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Commentary
Second Quarter 2012

Valkyrie

Richard Wagner wrote his monumental work, *Der Ring des Nibelungen*, over a 26-year period, 1848-1874. The *Ring* cycle consists of four operas,[1] usually performed over four consecutive nights. Everything about the *Ring* is colossal, from the supersized orchestration (the score runs 2,000 pages) to the dramatic storyline, as well as exhausting, for audience and performers alike. To stage this work a regular opera house would not suffice, so Wagner designed and built a special one, in Bayreuth, and premiered *Der Ring* in its entirety in 1876.

The plot is convoluted, centering on a magic ring forged in the Rhine River that grants the power to rule the world to whomever possesses it. Wotan, the chief god, steals the ring from the dwarf Alberich, but is forced to hand it over to two giants.[2] Wotan asks his son Siegmund, a mortal, to win the ring back, but Siegmund does not possess the free will that is a condition of capturing the ring. Meanwhile, Wotan's wife, Fricka, is furious that Siegmund has fallen in love with his twin sister, Sieglinde, who is married to Hunding, and orders Wotan to have Hunding kill Siegmund. Wotan sends his daughter, Brünnhilde, to make sure that Siegmund does not win the coming battle, but Brünnhilde intercedes to help her brother. Wotan is compelled by Fricka to intervene, destroys Siegmund's sword, and Siegmund is killed. Wotan then kills Hunding for good measure. For her disobedience, Brünnhilde is put into a deep sleep atop a mountain and condemned to marry any mortal who awakens her. Wotan surrounds the mountain with fires to keep all but the most intrepid away.

Sieglinde gives birth to her dead brother Siegmund's son, Siegfried, and dies in childbirth. Siegfried learns of Brünnhilde asleep

1 *Das Rheingold, Die Walküre, Siegfried und Götterdämmerung.*

2 Fafner and Fasolt are their names, if you care.

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on the mountain, not realizing she is his aunt. Fearless, he walks through the fire and awakens Brünnhilde and they become lovers. Siegfried leaves, falls in love with Gutrune, but her brother, Gunther, will allow them to marry only if Siegfried brings Brünnhilde back to marry Gunther. Siegfried does, then while out hunting, he is killed by Hagen, the dwarf Alberich's son who wants to recover the ring. Brünnhilde orders a funeral pyre for Siegfried, rides into the fire on her horse, grabs the ring and dies in the fire. The river overflows to quench the fire and the Rhine maidens, as instructed by Brünnhilde before she died, collect the ring and return it to the Rhine. They rejoice, but as prophesized, with the ring returned to the Rhine, flames engulf Valhalla, the hall of the gods and heroes, and they are all destroyed. Close curtain. Of course, this is a much-simplified version of the action.

"...a decision that would have consequences as dramatic, and as tragic..."

Southwest of Bayreuth about 300km, and 30 years after the first performance of *Der Ring*, a boy was born at the ancestral castle of the ancient aristocratic family of the Catholic Kingdom of Württemberg. Claus Phillip Maria Schenk studied literature, but was compelled to a military career and continued his family tradition of fine horsemanship by leading the 17th Cavalry Regiment based in Bamberg. Claus was commissioned a lieutenant in the German army in 1930, and led his unit into the Sudetenland in 1938 when Germany annexed that portion of Czechoslovakia. He marched into Poland the following year, precipitating the Second World War, and then fought in France the year after, when he was awarded the Iron Cross for bravery. He joined Rommel's *Afrika Korps* in 1942, and the next year in Tunisia suffered serious wounds when strafed by the Royal Australian Air Force. He was sent home to recover, but had lost permanently his left eye, right hand and two fingers of his left hand.

While recuperating, Claus reflected on the war, his religion, but mostly on how National Socialism had perverted his ideal of German society. During these months of convalescence, he came to a decision that would have consequences as dramatic, and as tragic, as *Der Ring des Nibelungen*.

Concerns grew in the second quarter as economic data disappointed and policy responses were inadequate to quell investor fears. Government bonds performed well in the quarter, led by UK gilts up nearly 4% and Treasuries up almost 3%. Both gilts and Treasuries are near their lowest yields in centuries (Charts 2 and 3 on page 3). The US dollar strengthened against every major currency, except the yen. Equities were much weaker, with declines in every market (well, Kenya did post

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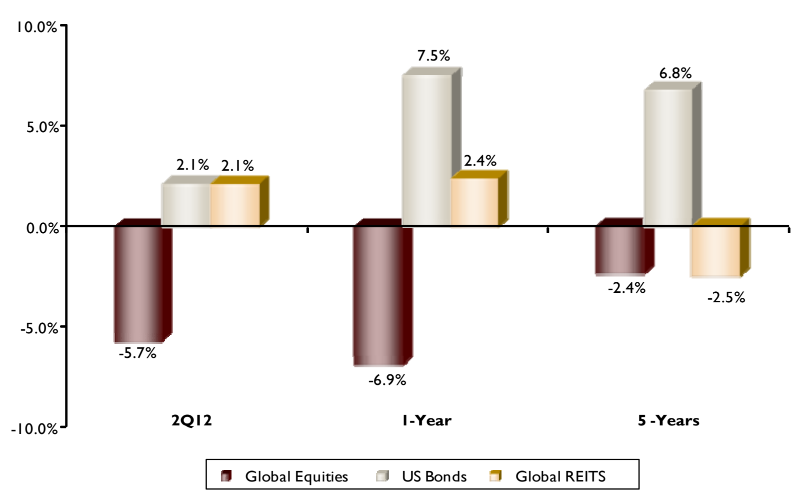
CAPITAL MARKET PERFORMANCE



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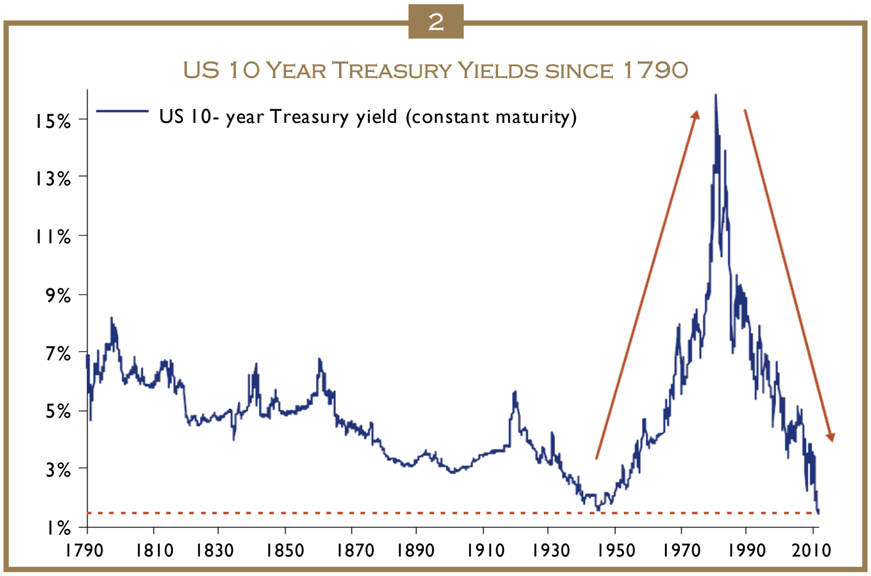
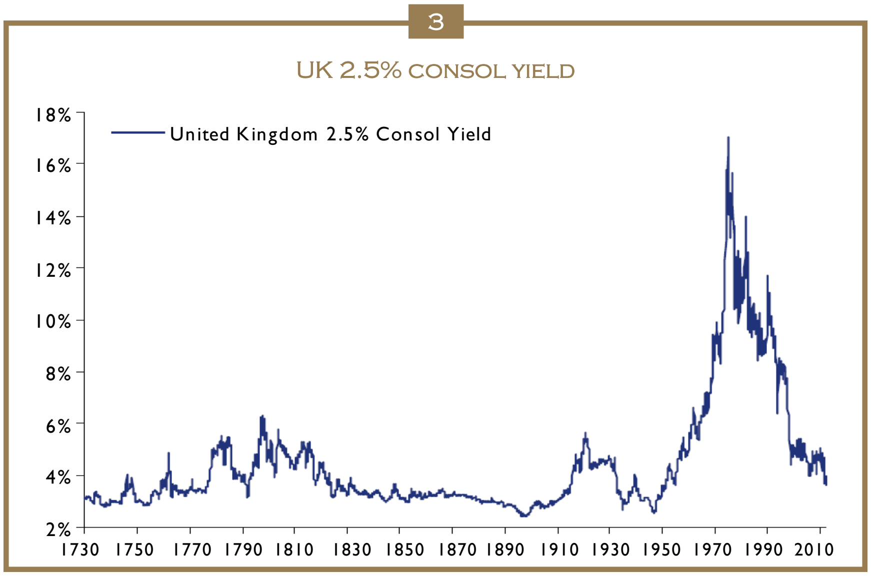


Monthly data
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

3



Monthly data. Data was unavailable July 1738, July 1769, August 1914-December 1914
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

a small gain). Argentina led the plunge, off 44% in the quarter, followed by Ukraine (-36%) and Greece (-31%, no surprise). All three of those markets have lost two-thirds of their value over the past year.

Commodities were hit particularly hard in response to weakening global growth, especially the energy sector, where oil lost 20%. Corn and soybeans, however, jumped as US temperatures soared. The past twelve months have been the warmest in the US since records began in 1895. More than half the country is in moderate-to-severe drought, the widest area since 1956, and 1,000 counties across 26 states have been declared disaster zones. Inventories of corn and soybeans are at record lows (Chart 4 on page 4), and prices for those crops have hit all-time highs.

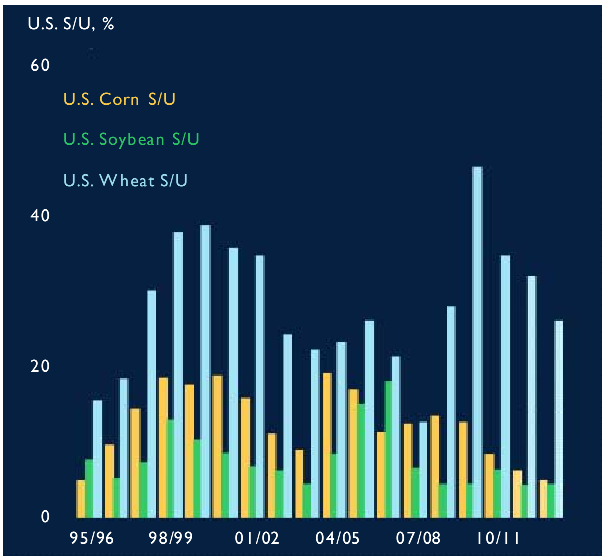
"...the warmest in the US since records began in 1895."

The good news for most Americans is that food represents a small portion of spending (about 14%), so the increases flowing through to overall prices is likely to be very small. In many developing countries, including China and India, food represents more than half of expenditures and consumers will be materially impacted. Shortages come at a time of rising demand for grains. As countries experience growing incomes,

> "...spiking grain prices that precipitated both the French and Russian revolutions."

4

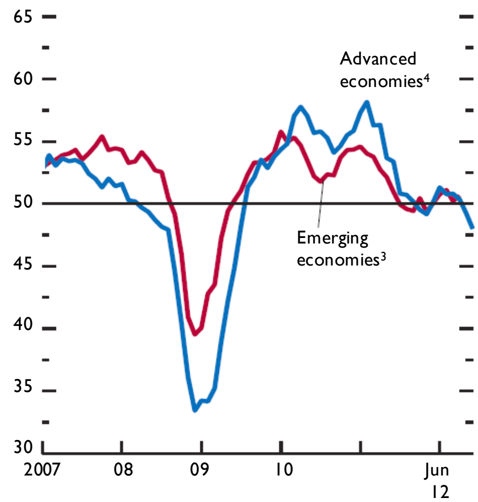
US Corn and Soybean Stocks to Use Falling Back to All-Time Lows



Courtesy: Morgan Stanley

5

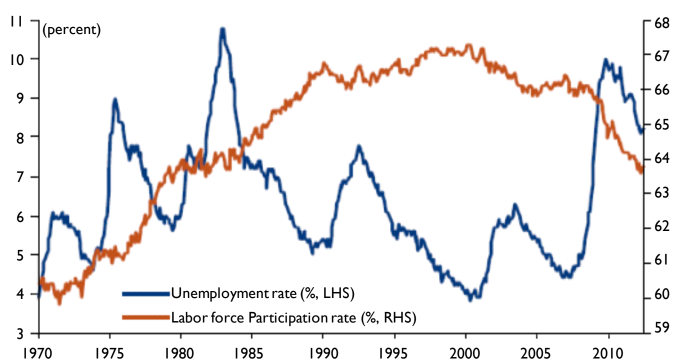
Manufacturing Purchasing Managers' Index



Source: IMF

6

Unemployment Rate and the Labor Force Participation Rate



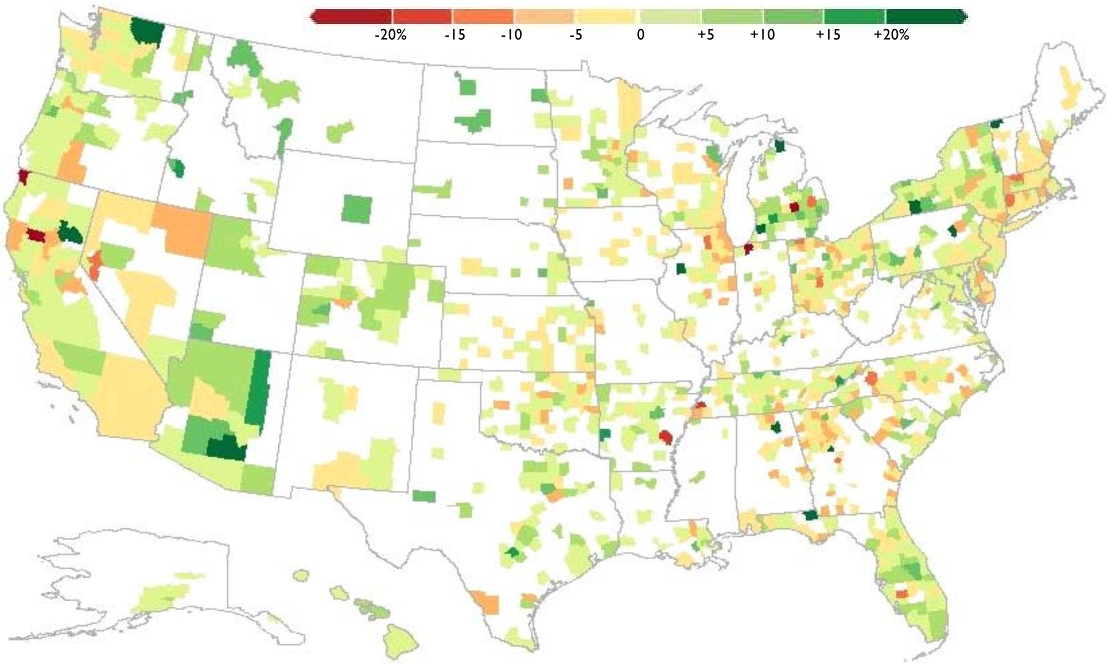
Source: BLS, BofA Merrill Lynch Global Research

meat consumption increases, multiplying the demand for feed grains, since to produce one unit of beef requires 11 units of grain (7:1 for pork and 3:1 for chicken). China had always been self-sufficient in corn, but last year imported 2% of its consumption, representing 4% of all world exports, and this is expected to double in the next few years. China already imports 60% of the world's soybean exports, twice what it was a decade ago, and this share too is expected to rise. Weather patterns will fluctuate, but demand for grains will continue to grow. With lower stocks, prices will move higher. Let's remember it was spiking grain prices that precipitated both the French and Russian revolutions.

Weaker economic data have appeared across the globe in the past few months (see Chart 5—the global manufacturing index). In the US, retail sales fell broadly for the third consecutive month, while employment gains have fallen sharply. Merely half of the 8.9 million jobs lost in 2008-2010 have been recovered, and only the sharp decline in the numbers looking for work has kept the unemployment rate from being higher than it is (at 8.2%—Chart 6).

7

Geographic Distribution of Year-over-Year House Price Changes
May 2012



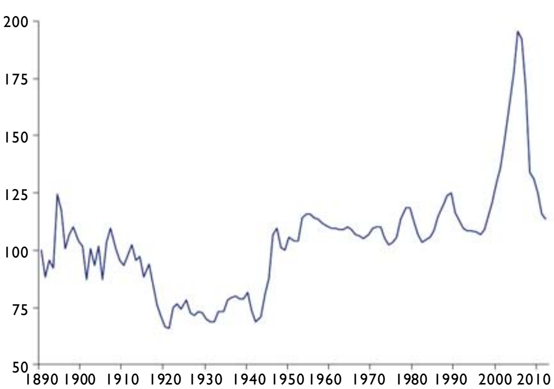
Source: CoreLogic

"After more than $1 trillion of defaults, housing appears to be stabilizing."

After more than $1 trillion of defaults, housing appears to be stabilizing. Prices are, on average, about unchanged from a year ago, although there is considerable variation throughout the nation (Chart 7). Across many countries over the centuries where we have data, housing shows very little real price appreciation (about 0.5% p.a.). The 85% surge in real prices from 1997-2006 was followed by a fall of more than 40%, nearly equal to the record 47% decline from 1894-1921, putting home prices back close to their long-term trend (Chart 8).

8

Annual real home price index



Annual data prior to 1953, quarterly thereafter (through 1Q12)
Source: BofA Merrill Lynch Global Equity Strategy, Case-Shiller

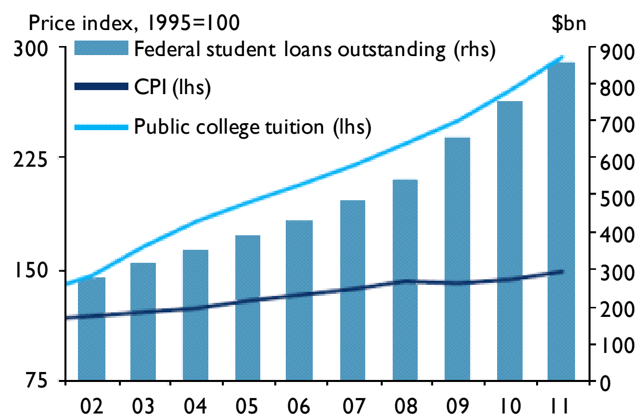
Households have reduced modestly their debt outstanding, but one area that has expanded significantly is student loans, which has benefitted from government support and subsidies. Student loans have doubled in the past five years to $1 trillion outstanding (Chart 9 on page 6). This now exceeds all credit card and auto loan debt. Half of those borrowers are not required to make any loan payments, and those that do have their payments capped at 10% of their income. As long as payments are being made, any principal outstanding after 20 years is forgiven.[3]

The explosion of student debt leads to three areas of concern. The first has been well-documented, that many borrowers fail to graduate, and are thus stuck with debt that is difficult to service. There is no credit check or any financial qualification a borrower must meet to receive a student loan, and for many, it is a burden they cannot bear. Secondly, the Department of Education has systematically underestimated the subsidy costs. As just one example, last year the department assumed it would collect $2.5 billion from borrowers in default; they actually collected half of that. So the future expenses of the program are likely to be much higher than budgeted. Thirdly, it should be asked, what role has this program had in increasing the cost of education, which has risen at twice the rate of overall CPI (see Chart 9 again)? Is it possible that a policy designed to make tuition more affordable has contributed to its rising cost?

"...the present value of all future government liabilities vastly exceeds the present value of future receipts..."

9

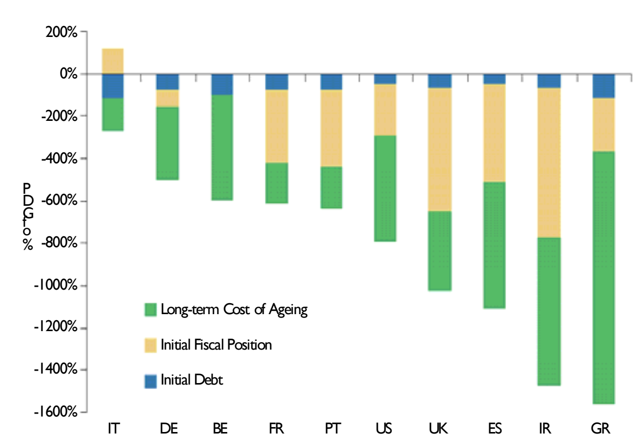
STUDENT LOANS OUTSTANDING



Source: College Board , BLS, Haver Analytics, Department of Education, Barclays Research

10

GOVERNMENT NET WORTH, 2010



Source: Arnaud Mares, European Commission, CBO, Morgan Stanley Research

Student loans are also just one, relatively small, aspect of future unfunded government liabilities. Pensions, and especially healthcare, represent enormous commitments that, as currently configured, appear impossible to meet. Underlying assumptions about distant cash flows are notoriously imprecise, but even with that allowance, the present value of all future government liabilities vastly exceeds the present value of future receipts, by many multiples of GDP. It is of no comfort that the US is not alone in this quagmire (Chart 10).

Growth in most developing economies has slowed in recent months. Certainly, a number of cyclical factors has contributed to the slowdown. Last year, most central banks in developing countries were tightening monetary policies to combat rising inflation. These policies are now reversing, but their impact was to retard growth, which we are now seeing.

There may be a deeper challenge as well. The growth model for emerging economies

3 These terms were recently changed from a 15% income gap and forgiveness after 25 years.

has largely been export-driven, primarily to the developed world. But consumption demand has slowed considerably in the US, Europe and Japan and does not look to accelerate appreciably (perhaps over any time frame). Additionally, the wage differential that drove much of the manufacturing development has eroded, not entirely, but sufficiently to the point where a number of manufacturers are planning to move capacity back to the US.

The focus on exports came at the expense of domestic economic development, although the details vary across countries. In China, consumption has lagged savings and investment, whereas in India, consumption has been strong, but investment has been lacking. In many commodity-based countries, such as Brazil and the Middle East (among others), the commodity sectors have been favored over other areas of the economy. If emerging countries are to continue their economic development, the old model may not be as efficacious as it has in the past. Adjustments, some significant, will have to be made.

China faces some specific challenges. Demographics are unfavorable: a recent survey found 30% of job vacancies are unfilled. Over the coming decade the number of non-college educated workers ages 15-39 is expected to decline by 130 million (the size of the entire US workforce), in stark contrast to the boom that fueled its manufacturing growth over the past decades.

There is some debate about whether there is a property bubble in China's major cities, but the average home price is about 11 times average household income in China; it's less than half that in the US.[4] Property values can fall substantially over a number of years (as many of us have learned). In Hong Kong, prices fell 70% following the 1997 transfer of sovereignty from Britain to China.

This leads to a common problem everywhere, but on a larger scale (as is everything in China): a misallocation of capital. This is evidenced in the extremely high savings rate and property boom, but also in oversized government spending on infrastructure. Government funding loans represent more than a quarter of GDP. Infrastructure is needed, but a good portion of this capital has been allocated to projects with very low (or negative) returns. Not only is this a poor return on investment, it diverts capital from being recycled into profitable enterprises.

The US, China, and others have their own sets of challenges, but these are dwarfed by the extended train wreck that is Europe. Greece's debt restructuring, with severe losses forced on private lenders but spared public debt holders, solved nothing, and Greece has a €3.2 billion principal payment due 20 August that it cannot meet. Little noticed was Cyprus' recent default and bailout that will cost (at least) another €13 billion. Also with little attention, Slovenia's borrowing costs have soared to 7%, and it may be the next bailout. Spanish debt trades at record spreads, and Italian bonds are close behind. In March, one-year Spanish debt yielded 1%, today it is 5%. Similar Italian debt has moved from 1% to 3.5%. Spain and Italy will need to borrow another €300 billion the remainder of this year and about €1.7 trillion over the next three years.

"...dwarfed by the extended train wreck that is Europe."

These borrowings cannot come from the markets at these levels for the simple fact that nominal borrowing costs cannot exceed nominal growth without creating, by definition, an unsustainable debt burden. Anyone who runs a business, or a household for that matter, can understand this simple math. Since growth throughout Europe is negative, and severely negative in the periphery na-

4 Median sales price in the US for a home is about $232,000, and median US household income is around $51,000, for a 4.5x ratio.

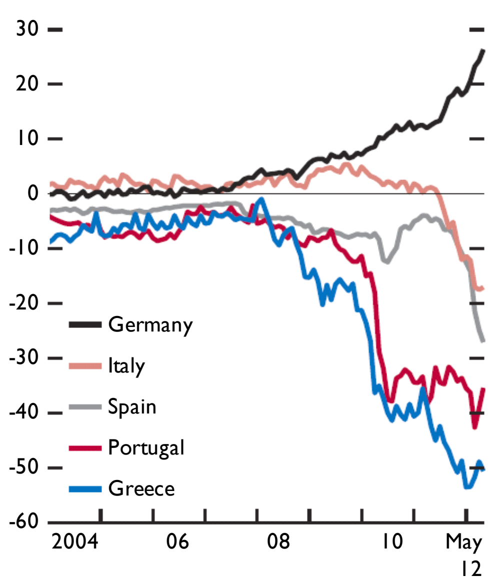
tions, the markets are, or soon will be, effectively closed.

Many see the European Central Bank (ECB) as the European equivalent of the Federal Reserve, but it differs in important ways. One significant difference is that in Europe the national central banks are responsible for implementing ECB policies. This is not true for the regional banks of the Federal Reserve System. This leads to wide differences in borrowing costs for businesses and households, country by country. Greek banks do not have access to borrowing at the ECB because Greek sovereign debt is not accepted as collateral. So Greek banks must borrow through an emergency liquidity assistance program from their national central bank, which is backed by the Greek government, which is insolvent. Many Spanish banks, particularly the smaller ones, are finding it more difficult to post acceptable collateral with the ECB, and a similar liquidity program may be needed soon in Spain that will be backed by the Spanish government that may soon be insolvent at many times the size of Greece. It is no surprise then that funds are flowing out of Greek, Spanish, Italian and Portuguese banks and into German ones (Chart 11).

"...there are economic and political challenges that go even deeper."

11

CLAIMS OF EURO AREA NCBS AGAINST THE ECB (PERCENT OF GDP)



Source: IMF

But there are limits to what a central bank can do. Initially, a solvency crisis coincides with a liquidity crisis, as we saw in 2008, and these twin crises are indistinguishable. The initial monetary response, injecting massive funds into the banking system, can appear to alleviate the "crisis," but in fact, it has only addressed the liquidity aspect, not the solvency issue. As the liquidity crisis fades, monetary policy becomes less effective because it is the solvency crisis that must be addressed by deleveraging (debt reduction) that occurs only through some combination of default, monetization, wealth transfer and/or growth. The US has managed through this process moderately well, but Europe has failed in all areas.

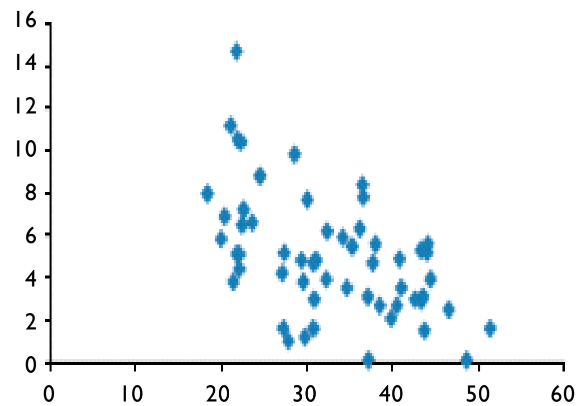
As difficult as it is to navigate the deleveraging process underway in most advanced economies, there are economic and political challenges that go even deeper. In the US, the huge entitlement programs simply cannot be funded. Additionally, we cannot continue to spend more than $1 trillion each year than we raise in taxes. We are already leaving an enormous burden to future generations to bear. Europe faces similar challenges, as the massive social welfare state cannot forever be sustained. Even before the debt problems, Europe's economy was sclerotic, a system of laws and regulations that aim to preserve rather than accrete wealth. Just one, small example: since 1975, all of Europe has created just one new company that is among the world's 500 largest;[5] in California alone, 26 have been started.

Germany and France, as the two largest economies in the Eurozone, and the two

[5] Inditex, of Spain.

12

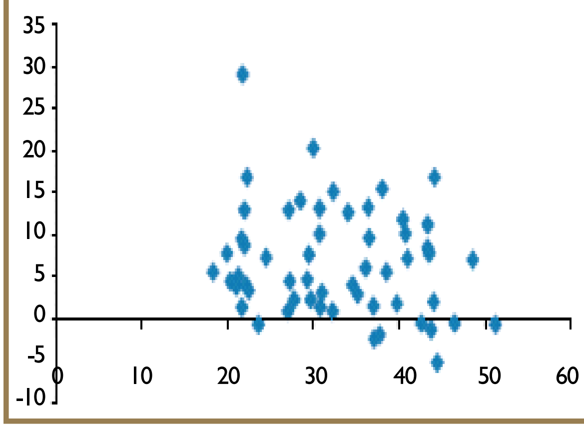
NOMINAL RETURN ON TREASURY BILLS, PERCENT



Treasury debt in the hands of public relative to nominal GDP, percent
Source: Ibbotson SBBI Classic Yearbook, U.S. Treasury, Morgan Stanley

13

NOMINAL RETURN ON INTERMEDIATE-TERM TREASURY SECURITIES, PERCENT



Treasury debt in the hands of public relative to nominal GDP, percent
Source: Ibbotson SBBI Classic Yearbook, U.S. Treasury, Morgan Stanley

"This is idiocy."

initial founders of the European Community[6], have long been united in their economic and political interests, but these interests are now diverging. France's economy is weakening faster, its debts growing and its borrowing costs rising. A credit downgrade is expected soon. These conditions move France's interests closer to Spain and Italy, away from Germany's. The political rupture may be more pronounced. The first acts of France's new socialist president, François Hollande, were to *lower* the retirement age to 60 years, to *reduce* the maximum workweek to 35 hours, to *lift* marginal tax rates to 75%, and to *raise* the minimum wage. This is idiocy[7], but regardless, it is clear to all, most importantly to Angela Merkel, the German Chancellor, that Germany is becoming ever more isolated in Europe. The markets assume that, in the end, Germany will agree to provide the funds and guarantees necessary to bailout the economies of Europe and save the euro, but that may not be a sure bet.

A surer bet is that interest rates and economic growth will remain repressed for some time. The reason is the high level of public debt. A recent study[8] identified 26 episodes since 1800 in advanced economies where the public debt/GDP ratio exceeded 90% for at least five years. On average, GDP was 1.2% lower, *per annum*, and this lower period of growth lasted 23 years. In many cases, debtors were able to secure access to funding at low real interest rates. In fact, in nearly half the historical examples real interest rates were lower during this time than in the previous period. The notion that markets will demand higher real interest rates in order to hold the debt of highly indebted nations is not supported empirically.

Looking only at Federal Reserve policy from 1955 to 2010, there is a statistically significant negative correlation between debt outstanding and realized returns on Treasuries (Charts 12, 13). The motivation is clear: governments with large debts are incented to minimize the costs of servicing those debts. Despite its theoretical political independence, the central bank is usually complicit in

6 The progenitor of it all was the European Coal and Steel Community Treaty of 1953.

7 Pardon my French.

8 *Debt Overhangs: Past and Present*, by Carmen M. Reinhart, Vincent R. Reinhart and Kennth S. Rogoff, National Bureau of Economic Research, Working Paper 18015, April 2012.

“An extended period of low real returns and slower than normal growth...”

this endeavor.

An extended period of low real returns and slower than normal growth is likely for investors in the advanced economies.

Following the First World War, the nobility was abolished in Germany, and nobles' titles were simply added as their last names. Hence, Claus Philip Maria Schenk became Claus Schenk Graf von Stauffenberg.[9]

After his convalescence, in September 1943 he became a lieutenant colonel in the Reserve Army whose principal duty was to implement Operation Walküre (Valkyrie), an order signed by Hitler to establish government control in the event of a collapse in civil order for whatever reason. It was to be triggered by a broadcast from the Reserve Army headquarters that Hitler had died, thus releasing soldiers from their oath of loyalty to him, and instructing the Reserve Army to assume command of all government offices.

Stauffenberg had a different idea, and with a few key collaborators, hatched a plan for General Helmuth Stieff, Chief of Army Operations, to assassinate Hitler while attending a military parade near Salzburg on 7 July 1944. Stauffenberg was to stay in Berlin, ready to broadcast the message that Hitler had been killed and for the Reserve Army to seize control of all government functions.

On the day of the parade, General Stieff could not bring himself to execute the plan. Stauffenberg decided then that he would try to get a meeting with Hitler, assassinate him himself, and then broadcast the news to implement Operation Valkyrie. Unsuccessful at first in arranging a meeting, he was told Hitler would see him on 20 July in his underground bunker in Berlin. The day before, he was informed that the meeting site had been changed to *Wolfsschanze*[10], Hitler's Eastern Front headquarters in Poland. Stauffenberg raced to get there.

He arrived with a briefcase containing two small bombs. In an anteroom, he attempted to arm the bombs, but this was a difficult task for someone with only three fingers and one hand. As he was arming one bomb, a guard entered, telling him the meeting was starting and he needed to get there immediately. He closed the briefcase with one bomb armed and entered the room with Hitler, Göring and Himmler. He placed the briefcase under the large oak conference table and, after a few minutes, excused himself.

The bomb exploded a few minutes later, and Stauffenberg was sure there could be no survivors. He quickly drove to the airfield and flew back to his offices in Berlin, and began calling his co-conspirators to prepare to implement Operation Valkyrie. But later that evening Hitler announced himself on the radio that he had survived a bomb attack, and Stauffenberg then knew his plan had failed. He was captured that evening and shot a few hours later by a firing squad.

Valkyrie in Old Norse means “chooser of the slain.” In Norse mythology, Valkyries were female figures who decided who would die and who would win in battle. Among the dead, they would choose the heroes to be brought to Valhalla, hall of the gods.

Brünnhilde was a Valkyrie. She had been instructed by Wotan to see her brother slain, but she disobeyed. She knew this would have severe consequences for her, but did not believe it was her father's true desire to see his son killed, nor did she think it was the right course of action. She paid for her transgression with banishment, and in the end, Siegmund was killed anyway. He is brought to Valhalla by the other Valkyries

[9] *Count of Stauffenberg.*

[10] *Wolf's Lair*

with one of the most famous pieces in all of music.[11]

Despite her failure to prevent Siegmund's death, Brünnhilde exercised her free will. Likewise, Claus von Stauffenberg failed in his attempt to assassinate Hitler, and paid for it with his life, but we admire him for following his conscience and acting upon it, especially as so few in Nazi Germany did.

Stauffenberg accepted a personal responsibility for the sins of the Nazis, and took action. He embodied the concept of virtue, which means a moral excellence. Unfortunately, it seems that virtue is particularly absent today among the leaders of our society. Where is the condemnation for the bank that launders Mexican drug cartel money, and the apology and resignation of those responsible? Where is the condemnation for the banks that defraud their customers, and the apology and resignation of those responsible? Where is the condemnation of politicians that threaten to default on our contractual obligations in order to advance their special interests? Where is the condemnation when these politicians persist in promulgating policies that favor minority groups over the common good? And why do we support and re-elect them?

The good news is that we have the capability to act, and we must. If we continue to do business with companies that defraud us, we are complicit in their crimes. If we continue to elect politicians that pander to special interest groups, we are complicit in the dysfunction of our government. In the end, we are all, collectively and individually, responsible. Claus von Stauffenberg saw the world in these terms, and sacrificed his life trying to reverse the Nazi terror. He chose protest over silence, action over complicity, virtue over dishonor. We face similar choices, and like the Valkyries, *we* choose who enters Valhalla and who doesn't.

[11] *Ride of the Valkyries* opens Act III.

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