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The End of History (Again):

Why We May Be Living in a Permanent Financial Crisis

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In his 1989 essay,[1] and more fully in his later book,[2] Francis Fukuyama famously proclaimed "the end of history." What Fukuyama meant was that with the demise of the Soviet Union and the end of the Cold War, Western liberal democracies represented the end point of mankind's sociocultural evolution, "the universalization of Western liberal democracy as the final form of human government."[3]

We'd like to suggest, instead, that the West has reached the end of its own socioeconomic evolution and is now faced with the gargantuan task of reinventing itself. Thus, the West must create new cultures, new governing mechanisms, and new theories for how governments can support themselves. Needless to say, the investment implications of this are large and complex.

We'll begin with the proposition that the West is in a permanent financial crisis. By "permanent," we mean a period of years that is meaningful even for long-term investors. Specifically, we will consider the possibility that recent events – the credit crunch, stock market collapse and banking crisis in the US, and the sovereign debt problem, banking crisis, and stock market collapse in Europe – are merely symptoms of a deeper and far more complex problem that will require decades to sort out. We will also consider how investors might position themselves to avoid the destruction of their capital over an extended period of crisis.

❖ A Permanent Financial Crisis?

The current financial crisis began in the summer of 2007 with the credit crunch and continues with the European sovereign debt and banking crisis. More than four years after the crisis began, US equity markets are nowhere near their 2007 high of 14,141 on the Dow. Bill Gross, of PIMCO, has declared The New Normal, an environment characterized by lower-than-normal economic growth, higher-than-normal unemployment, and unattractive market returns.

Yet most long-term investors have taken the position that "this, too, shall pass." That is to say, most investor portfolios are positioned near their long-term targets, targets that were developed using long-term risk and return assumptions that haven't played out for a decade. Indeed, over the past

[1] Published in the current affairs journal, *The National Interest*.

[2] *The End of History and the Last Man*, which came out in 1992.

[3] This probably came as news to the fundamentalist Islamic states that have cropped up since Fukuyama wrote – to say nothing of China.

thirty years, bond returns have outpaced stock returns, an outcome that turns market theory on its head.

Investors are aware of all this, of course, but are now reduced to hoping that the markets will mean-revert, as they usually do, meaning that in the coming years returns should be much better than they have been in the past and that the traditional relationship between risk and return will reassert itself.

No doubt all that will happen, but the question is, "When?" In their seminal work, *This Time Is Different: Eight Centuries of Financial Folly*, Carmen M. Reinhart and Kenneth S. Rogoff make the point that recovery from the deepest financial crises takes, on average, ten-to-twelve years.[4] If we measure from 2007, it's possible that we still have more than five years to go before we will have fully recovered. And if the Western countries should slip into a Japanese-style "lost two decades,"[5] well, all bets are off. Looking back from, say, 2030, our children could find to their sorrow that equity returns have been far below par for half a century.

❖ The Cause of the Crisis Matters

We began by asking a naïve question: Why are all the Western liberal democracies so indebted?[6] Aren't these countries, we asked, the wealthiest societies in the history of civilization? If ever there were economies that could support themselves without recourse to massive borrowing, aren't these the ones? What, we naively asked ourselves, gives?

A financial crisis can arise from a variety of causes, but the principal cause is a sovereign debt burden beyond what can be borne by the wealth of the society without causing social instability. Sovereign indebtedness can arise directly from government over-borrowing, or it can arise indirectly,

[4]Reinhart and Rogoff, pp. 234-237. A separate study by David H. Papell and Ruxandra Prodan puts the average time for recovery after a financial crisis at nine years: "[T]he Great Slump is not yet half over." See *The Statistical Behavior of GDP after Financial Crises and Severe Recessions*, prepared for the Federal Reserve Bank of Boston conference on "Long-Term Effects of the Great Recession," October 18-19, 2011. Note that the Japanese crisis began in 1992 and is ongoing – twenty years and counting.

[5]The Nikkei Index, which measures the performance of the Japanese stock market, peaked at over 24,000 in 1992 and is now hovering around 8,000.

[6] By "indebted," we include both the sovereign debt that has destroyed places like Greece and the private debt that destroyed places like Ireland and Spain.

via (for example) guarantees of bank deposits or mortgage debt, or via government bailouts of private financial institutions.

But the important question is not simply *how* the indebtedness arises, but *why*. Imagine, as a hypothetical, that a country has incurred a huge external debt in order to fund significant infrastructure expansion. Presumably, this is really an investment in future growth, which should enable the country to repay the debt easily.

Suppose instead that a country has incurred its debt as a result of ongoing societal demands for current spending beyond what can be supported by the country's budget. Or imagine that private borrowers in the country have incurred massive debts to buy, for example, bigger houses. To bail out the foolish lenders to these foolish borrowers – after all, no one wants another global banking crisis – the country has to bail out the lenders, effectively transferring private borrowing into sovereign debt.

This hapless country is now faced with the problem of discharging a vast debt that is still growing, because the societal demands are still there. The situation, in other words, seems to be completely hopeless. Even if the country can somehow find the means of discharging its huge existing debt, that debt will simply rebuild itself unless something can be done about the spending demands that are responsible for the debt, or unless additional sources of revenue can be found to support the spending demands.

As a thought experiment, let's adopt the postulate that, in the advanced Western democracies, social norms have evolved to require minimum standards of living that exceed ability of even those wealthy countries to pay. In other words, social goods that even a few decades ago would have been deemed unattainable by the great mass of the populace are now considered to be inalienable rights of all: access to universal health care (and damn the cost!), a dignified retirement and old age (whether we have saved our money or not), education through the baccalaureate degree, freedom from hunger, home ownership, and so on. These are "rights" about which there has grown up a broad consensus – indeed, anyone who espouses a reduction in these rights is usually perceived as a barbarian.

Thus there is, we are positing as part of this thought experiment, a very serious disconnect between what the citizens in Western societies believe they are owed by their governments and what those governments can actually afford to deliver. Let's step back a few hundred years and see how we've managed to get ourselves into this position.

❖ The Industrial Revolution and Its Aftermath

Before about 1800, the wealth of human societies had been largely stagnant for thousands of years. But once the Industrial Revolution began – surely it was the most important event in the history of human civilization – societal wealth began to grow at unprecedented rates. Between the end of the Eighteenth Century and the end of the Twentieth Century, average incomes would grow ten-fold at the same time that the population was growing six-fold. This astonishing increase in human wealth came about for a variety of reasons that are still not fully understood, but clearly implicated were scientific and technological progress, the protection of property rights, the rise of representative democracies, intense competition among the industrializing countries, vastly improved health, and so on.[7]

Whatever the cause of the increased wealth of societies, it would have extraordinary consequences, not the least of which was how the wealth should be distributed. Western societies differed in how wealth should be spread around, but they all agreed that it should be vastly more widely distributed than it actually was by the late Nineteenth Century.

Over the course of the Twentieth Century the industrializing world[8] would experiment with three strategies that were designed to capture and redistribute the wealth created by the Industrial Revolution (and, later, the Post-Industrial Revolution). These strategies were, in rough order of their appearance:

- Seizing control of the means of production
- Taxing wealth and income
- Borrowing

In each case, demands by the public for services fairly quickly overwhelmed the capacities of each strategy, causing the state to move on to the next. As noted above, our thesis is that it is simply inherent in Western liberal democracies that demands will – eventually, but always – outstrip the supply of money available to pay for them. As a result, having exhausted all three known strategies for wealth capture and redistribution, the West has reached the end of its history and must reinvent itself.

[7] See, for example, Niall Ferguson, *Civilization: The West and the Rest*.

[8] We're going to focus on Europe, where the Industrial Revolution began, although of course the US was facing the same issues at roughly the same time.

Note that we are not concerned here with the question of whether any particular wealth redistribution scheme is fair or equitable. We would note that the wealthy as a group don't seem to have been particularly harmed by the various wealth redistribution schemes (although of course individual wealthy families were decidedly harmed). And in any event whatever harm was done to the rich was far outweighed by the harm the rich have done to themselves.[9] We are only interested in the effectiveness and consequences of the wealth redistribution strategies.

Far and away the most interesting way to follow the launch, triumph, and ultimate failure of each of the three wealth-distribution strategies is to look at the remarkable experiment that Western Europe has been conducting since the end of World War II.

❖ The Great (and Strange) Experiment

From the fall of Rome until 1945 – roughly 1,500 years – the European states were more or less constantly at war with each other. Since the Europeans quickly became the most powerful peoples on earth, there wasn't much anyone could do about this. The devastation gradually increased in savagery, reaching its cataclysm in the Twentieth Century when Europe launched two world wars in the span of twenty-five years.

But at the end of World War II, two countries – the upstart USSR and the upstart United States – emerged as vastly more powerful than the traditional European states. Determined that no more wars would come out of Europe, the USSR and the US essentially colonized the Continent. In the east, the Soviet Union created fairly traditional colonies across Eastern Europe, establishing puppet regimes that reported to Moscow, stationing troops on Eastern European soil, demilitarizing the area, and, when the colonies got out of line, invading them (Hungary in 1956 and Czechoslovakia in 1968).

In the west, the US took a softer line, but still imposed (democratic) regimes on countries that didn't have them, stationed troops on Western European soil (where they remain to this day)[10], and demilitarized the area. America didn't invade Europe, but that's because it didn't have to, as the

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[9]Shirtsleeves-to-shirtsleeves in three generations. This phenomenon is so universal that similar aphorisms exist in other cultures: Rice paddies to rice paddies in three generations (Chinese). Potato fields to potato fields in three generations (Irish). We are indebted to Jay Hughes for the non-US versions. See James E. Hughes Jr., *Family Wealth*.

[10] The official occupation of Germany ended in 1955, but US troops remain on German soil as part of NATO.

Europeans remained loyal allies of the US. But suppose some Western European country – let's say, Italy – had elected a Communist government and that government had seized total power, begun to build up its military might and announced that it was leaving NATO and joining the Warsaw Pact. American troops would have been in Rome faster than you can say "lasagna."

Still, the "colonization" worked. After suffering two world wars in a quarter century, Europe has been at peace for almost seventy years. And during this long and remarkable concordance, the softer American approach allowed Western Europe to experiment with various methods of organizing itself politically and economically. (This sort of experimentation was severely restricted in Eastern Europe until the fall of the Soviet Union.)

Note, however, that this experimentation occurred in a strange petri dish of a world in which some of the wealthiest countries on the planet had no need to see to their own defense. In the history of the race, nothing like this had ever happened. Throughout history any country, wealthy or not, which failed to defend itself was soon enslaved, and this went doubly for a wealthy country. The best example, of course, was Rome, which allowed its security apparatus to decay and was promptly conquered by a bunch of naked tribes from Northern Europe.

But in Western Europe more than a dozen hyper-wealthy countries have existed for seven decades without giving a thought (or a euro) to their own security, which was instead guaranteed by the US nuclear umbrella. It didn't have to be this way, of course, as shortly after World War II a common European army was proposed.[11] The idea was to enable Europe to see to its own defense and, not incidentally, to keep Germany from rearming on its own. However, the proposal was defeated in France in 1954 and was never seriously reexamined.

As a result of this extraordinarily extended adolescence, none of the European countries (with the slight exception of Britain) had to develop any serious military capability. Instead of spending huge sums on defense, as the US has done for many decades, they could spend virtually their entire annual budgets on civilian needs. And these needs grew and grew and grew.

We mention this issue because it is often overlooked. The rest of the world can take many lessons from Western Europe's seventy years of socioeconomic and political experimentation, but few countries anywhere can ever expect to be so fortunate as to emulate the European experience.

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[11]The European Defense Community (EDC) was proposed by France in 1950 and was to include West Germany, France, Italy, and the Benelux countries.

But let's set aside the fortunate circumstances of Western Europe and focus on one aspect of the Great Experiment: how to capture and redistribute the extraordinary wealth of that part of the world.[12]

❖ Seize the Means of Production!

Marx famously believed that conflicts between the middle class owners of productive enterprises (the "bourgeoisie") and the workers in those enterprises (the "proletariat") would result in the collapse of capitalism. When this happened, the workers would seize control of the government, ban private ownership, and all profits would thereafter accrue to the state, which would redistribute the wealth far more broadly.

Such a revolution actually did occur in Russia, and the state did in fact ban private property. And for a while, this worked magnificently, as Russia evolved from a backward, peasant society into the second most powerful country in the world in less than thirty years (1917 – 1945). Unfortunately, once the USSR's simple industrial society found it necessary to evolve into a vastly more complex post-industrial society (to compete with the US), top-down command strategies proved to be no match for bottom-up free market strategies, and the USSR went the way of the dodo bird.

In Western Europe, pure Communism in the Marxist sense was never adopted. Instead, Europe found a "middle way." Socialist governments dominated the landscape for many years after World War II and those governments tended to nationalize not the entire economy but only the most important industry sectors – especially banks, infrastructure (transportation, communications and energy) and large employers. Smaller enterprises were generally permitted to remain in private hands. The idea was to control the destiny of the economy and capture the profitability of the large enterprises so that wealth could be redistributed.

But Europe found, as the Soviet Union found, that state ownership of a corporation soon converted it from a Golden Goose into a Ward of the State. Instead of enjoying large profits that could be redistributed, the Europeans found that state-owned enterprises misallocated capital so badly that they had to be subsidized to keep them from collapsing. And since they were far and away the largest employers in the countries, subsidized they were, nearly bankrupting their owners.

[12] To simplify the discussion we are describing the wealth-redistribution strategies as though they occurred in strict chronological order. In fact, of course, the strategies overlapped in time.

Eventually, even the most *dirigiste* Europeans saw the light – partly because Margaret Thatcher shined it vividly into their eyes – and began rapidly privatizing the state-owned enterprises. The first wealth-redistribution strategy, seizing the means of production, had hit the wall.

❖ The Power to Tax Is the Power to Destroy – Societies[13]

If the Europeans couldn't succeed by seizing the ownership of productive enterprises, the next logical step in funding entitlements was to tax the profits produced by those enterprises. Profits were taxed at the corporate level, of course, but the serious money was raised by taxing individuals.

When income taxes were first introduced, rates were very low (7% in the US, for example) and compliance was laughable. But after World War II, and especially in the 1970s, when state-owned enterprises began to implode, tax rates skyrocketed. In Britain, top marginal rates stood at 98% as late as 1979.[14] Such rates so suppressed initiative, and so crushed private enterprise, that it seemed as if everyone in the UK was on-the-dole.

And in fact, everyone was on the dole, not just in Britain but across Europe. Since it wouldn't make sense for middle class taxpayers to pay out in taxes more than they were getting back in entitlements, the only people who were net taxpayers were the wealthy. And once the wealthy had been squeezed dry, the party was over. As Margaret Thatcher was fond of pointing out, if your strategy is to pay for ever-increasing entitlements with ever-fewer people's money, you will soon run out of other people's money.

There are two fundamental problems with very high, very progressive tax regimes. The first, already mentioned, is that they destroy initiative. Even to this day, Europe (outside of post-Thatcher Britain) has virtually no venture capital industry and hardly any entrepreneurialism of any sort. In the US, we tend to view entrepreneurs as economic heroes, creating jobs and developing products and services that increase human wellbeing. But in Europe, entrepreneurs are frequently viewed as troublemakers.

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[13] Words to this effect were first spoken by Daniel Webster, arguing before the US Supreme Court in the case of *McCulloch v. Maryland* in 1819. The question before the house was whether a state could impose a tax on the Bank of the United States, a doomed predecessor of the Federal Reserve Bank. Chief Justice Marshall adopted the same words in holding that it could not. We are suggesting that the power to tax is capable of destroying not just entities and individuals, but entire societies.

[14]The top regular bracket was 83%, but there was also a 15% soak-the-rich surcharge on interest and dividends, bringing the total rate to 98%.

The second problem has to do with progressivity itself. While certainly most people agree that higher income taxpayers should pay more than lower income taxpayers, the argument for highly progressive marginal rates rests on a very thin reed. Originally, progressivity was viewed in the same spirit as the Communist slogan, "From each according to his ability, to each according to his need." It sounded good, but reality acted like a glass of ice water tossed in its face, and today the spirit of the slogan exists nowhere except in the tax code.[15]

When the sloganeering justification for progressivity evaporated, the arguments for highly progressive tax rates became increasingly disingenuous: mainly, "we need the money," and "it's very popular." Obviously enough, the fact that one group of (middle class) citizens desires more entitlements is hardly a reason to confiscate other citizens' income: one man's "fair share" is another woman's confiscation of her hard-earned income.

The popularity issue has also evolved amusingly over time. As long as high marginal rates apply to only a few wealthy taxpayers, progressivity is naturally popular. But that doesn't make it fair. Indeed, once one's own ox begins to be gored, one's enthusiasm for progressivity evaporates very quickly. The best – and, really, the decisive – example is right here in the US: the Alternative Minimum Tax. Originally enacted in 1969 as the "Minimum Tax," it applied to a tiny handful of taxpayers – 154 of them! – who reported more than $1 million of income but paid no tax (perfectly legally). The AMT was for many years the most popular provision in the tax code.

But by the late 1990s more than 600,000 taxpayers were ensnared by the AMT, and today more than four million taxpayers pay it. Guess what? It's the single most hated part of the tax code – which is saying something.

Once Margaret Thatcher was elected Prime Minister in the UK, she placed herself firmly astride the tracks down which the train wreck of Britain was hurtling. She quickly focused on reversing the disastrous policies that had led to precipitous national decline: she sold state-owned enterprises, broke the unions' stranglehold on the economy, and promoted more broadly flexible labor markets. Most important for our purposes here, she ratcheted down tax rates.

Counterparts to Mrs. Thatcher were in short supply elsewhere in Europe, but even the leftwing socialist parties gradually recognized that sky-high and ever-rising tax rates weren't improving the quality of citizens' lives. Instead, economic growth had come to a halt and Europe was falling dangerously behind the US and the emerging economies (especially, the "BICs," ignoring Russia).

[15]If you are skeptical, try paying your workers according to that principle and see what happens to you.

Without changing their names or, nominally, their ideological positioning, Europe's socialist parties began moving rightward, and tax rates across Europe began to come down.

As had happened with seizing private property, using the power to tax to redistribute wealth had worked for a while. But the power to tax really is the power to destroy – to destroy not wealthy taxpayers, but entire economies. Europe had, in fact, run out of other people's money.

❖ "Borrowing … the Disease Is Incurable"[16]

By the end of the 1980s, you could almost see the desperation in Europe's eyes. Economic growth was flat, other economies around the world were surging ahead, and the two obvious means of raising revenues to support entitlements had died of natural causes.

But the Great Experiment isn't called the Great Experiment for nothing. In 1992 the Maastricht Treaty established the European Union under its current name and required that all countries in the EU adopt the euro.[17] From the very beginning it was recognized that one great advantage of the euro was that it would allow everyone in the currency union to borrow at rates formerly offered only to its most creditworthy states. The idea was that low borrowing rates would spur economic growth across the Continent.

This might actually have worked out as hoped – indeed, like the first two revenue-raising strategies, borrowing initially worked. In the aggregate, European growth rose, although in real terms most of that growth was isolated in the northern countries. There are, after all, good reasons for countries to borrow money. Short-term borrowing can smooth otherwise seasonal cash flows, for example. Long-term borrowing can be used to build out infrastructure – roads, railroads, pipelines, airports, the Internet backbone – which is really a form of investing in the long-term growth of the society.

When borrowing rates are low, and even more especially when low-credit countries are able to borrow at rates more appropriate to high-credit countries, and most especially of all when countries

[16]Shakespeare, "Henry IV, Part 2."

[17]Actually, thus far only seventeen of the twenty-seven states of the EU use the euro. Many of the others don't meet the budgetary and monetary requirements (and others claim to but don't). Denmark and the UK opted out and Sweden, though a member of the EU, refuses to use the euro by intentionally not meeting the requirements.

are desperate to meet entitlement demands and all their other strategies have run out of steam, the temptation to over-borrow is over-whelming.

And over-borrow is what the Europeans did, as we all know. The borrowing wasn't designed to smooth out seasonal cash flows and it wasn't designed to fund infrastructure spending. No, it was designed to fund current spending, with virtually all that spending being used to fund middle class entitlements. When a country's borrowing is mainly to support current spending, it isn't long before a large part of the borrowing is used up paying interest on past borrowing. Soon enough, "current spending" mainly means paying interest on past spending, at least in terms of discretionary versus non-discretionary spending. At that point, the jig is pretty well up. And if interest rates demanded by bond investors should move up sharply, matters end quickly and badly.

Reinhart and Rogoff have shown that once sovereign indebtedness reaches about 90% of GDP, the competitiveness of a country begins to decline, as the burden of interest repayment eats into more productive spending. At ratios above 90%, average growth declines, according to Reinhart and Rogoff, by about 1%.[18] Of course, this paints with a broad brush. Economies that are especially robust can carry higher debt loads. Countries whose debt is mostly internal, rather than external, can carry higher debt loads. As noted, countries spending heavily on infrastructure can carry higher debt loads. Unfortunately, none of this applied to Europe, where economies were feeble, debts were externally held, and borrowing was in support of current spending.

Since the over-borrowing in Europe was, at least in the intermediate term, in everybody's interest,[19] over-borrowing continued endlessly while everyone winked at the Maastricht Treaty's supposed debt limits (60% debt-to-GDP) and budget deficit limits (3% of GDP) and partied on. As we know, this ended catastrophically for the countries that had borrowed the most, and all of Europe will be paying a steep price for decades. The last and final revenue-raising strategy has blown up in the Great Experiment's face.

❖ Now What?

After the end of World War II, when the European Great Experiment really began, countries were faced with powerful demands for ever-increasing entitlements from the middle classes whose

[18] Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt," paper prepared for the *American Economic Review Papers and Proceedings* (Draft of January 7, 2010), pp.7-8.

[19] That is to say, most of Europe wanted to borrow to offer ever-more-generous entitlements to their citizens, and Germany wanted everyone else to borrow so it could keep the German export economy booming.

votes elected every government. The result was an ongoing and increasingly desperate search for ways to raise the revenue required to meet the demands. Fail, and another party would be elected that would certainly find a way to do it.

As we have seen, the main strategies employed by governments to meet rising entitlement demands were (a) seizing control of the means of production, (b) taxing wealth and income, and (c) borrowing. All worked for a time, but all eventually failed.

As this is being written, all eyes are on Europe, as the Continent struggles to avoid a domino-like collapse of sovereign countries and an associated collapse of the European banking system. But note that Europe's current troubles, calamitous as they are, are merely symptoms of the larger and vastly more formidable problem: the middle classes who elect governments are hooked on their entitlements, and those entitlements can no longer be afforded.

Yes, Europe needs to find ways to stave off its current crisis, but even assuming it is successful in avoiding the collapse of the euro and the banks and the EU, only then can it begin to deal with the larger, vastly more complex challenge of learning to live within its means. And note that almost anything Europe does to stave off collapse will likely constrain economic growth for a very long time, making the problem of living within its means even more daunting.

The question therefore arises: How are the Western democracies – very much including the US – going to get themselves out of this mess? Well, actually, that's not our department.[20] The reason it's not our department is that, theoretically, it's perfectly clear what has to happen: entitlements need to stop growing and start shrinking, and government revenue needs to grow so we can start paying down our gigantic debt burdens. And all that needs to happen without plunging the Western economies into recession or worse.

"Theoretically," as Yogi Berra is fond of saying, "Theory and reality should be the same." But in reality, they usually aren't. Everybody on the planet knows what has to happen, but getting there seems to be politically impossible, not least because none of the old ideas have worked and nobody has any new ones.

Consider Greece. If ever there was a country that had its back to the wall and was facing gathering ruin, it would be the Greeks. Yet the country has undertaken virtually no serious reforms

[20]We are channeling Tom Lehrer, who in his famous lyric put these words into the mouth of Wernher von Braun, the controversial German-American rocket scientist: "'Once the rockets are up, who cares where they come down?/That's not my department,' says Wernher von Braun."

beyond those forced on it by the bond markets. Or consider Italy. Though its economy is barely one-seventh the size of the US, it is the third largest issuer of sovereign debt in the world. We know why, and we know what Italy has been spending its spectacular borrowing on. Yet the country seems to be in serious denial. In the fall of 2011 Italy attempted to placate bond vigilantes by announcing that it was considering raising its legal retirement age from 65 to 67 – over eighteen years![21]

Or consider, we are sorry to say, the United States of America, where debt to GDP has gone over 100%,[22] where the economy is flat on its back, where Congress can't act at all, where the Super Committee collapsed in a shambles, and where any third grader can see that middle class entitlements will sink the country very soon.

It's fun to bash Congress, and we're all in favor of it. But the fact is that Congressional deadlock merely reflects voter deadlock. Unelected commissions (viz., Simpson-Bowles) are always coming up with perfectly sound ideas, but nobody who needs to stand for election will go anywhere near them. It's true that opinion polls show a plurality of Americans agree that the best solution to our problems involves a combination of curtailing entitlements and raising taxes. But ask the question slightly differently and watch what happens to you:

> Pollster (interviewing Medicare recipient): Do you agree that Medicare should be curtailed and your taxes increased?
>
> Medicare recipient: #@*&!

In any event, broad public opinion has little impact on what happens in Congress, since our Representatives (especially) and Senators are elected from specific districts and states. Imagine, for a moment that, Nancy Pelosi were to announce that she was going to vote to cut Medicare and Social Security. The poor woman would be tossed out on her ear and replaced with somebody who knew where her bread was buttered. The same goes for, say, Eric Cantor.

But the problem is actually worse than that. Congressional representatives on the political left believe very deeply that the role of government is to make people's lives better, and cutting "entitlements" is morally anathema to them. Same for folks in Congress on the political right, who

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[21]More recently, a new-and-improved Italian government proposed that henceforth women in the private workforce would have to wait and retire at the same age as men(!).

[22] See US Department of Commerce, Bureau of Economic Analysis, "National Economic Accounts: Gross Domestic Product: Current-dollar and 'Real' GDP." BEA.gov, July 29, 2011.

believe to the core of their souls that entitlements are bankrupting America. To ask such people to vote against their most deeply held principles is a non-starter.

The Western democracies aren't precisely out of ideas, they are out of ideas that will work and can be implemented.[23] Many commentators have observed that the Occupy Wall Street protestors haven't offered any solutions to their concerns. True enough, but who exactly *is* offering any solutions?

In addition to the paucity of realistic ideas, the West is also faced with a very disconcerting fact: we now know that failed ideas for redistributing wealth to the middle classes don't just fail to work, they have consequences that are cataclysmic. When state ownership of productive enterprises failed in the Soviet Union, it didn't just set the Russian people back a few years, it set them back roughly a century: relative to other societies in Europe and elsewhere, Putin's Russia occupies about the same place in the world as Czarist Russia did in the early 1900s. Europe's "middle way" allowed it to avoid this calamity, but its long flirtation with socialism built up a culture that was, and remains, anathema to the sort of individual initiative that propels growth.

By the time high and highly progressive tax policies failed, Europe was suffering – the rich had been bled dry and there was nowhere else to turn. Britain in particular was sinking slowly into the English Channel, at whose bottom it would be lying today if Margaret Thatcher hadn't come to power.

And, of course, we all know how ruinous Europe's flirtation with borrowing turned out to be. Just to take the worst example, Greece today is the laughingstock of the world. But it wasn't always thus, and we aren't just referring to the Greece of 2,500 years ago. Not so long ago, the Greeks were a proud and virile society. As World War II was breaking out, tiny Greece (whose total population made it roughly the size of the city of Berlin) met the Axis army at its border and, astonishingly, pushed it back into Albania. Greece was doomed, of course, as it couldn't stand forever against the combined might of Germany and Italy. But when the Greeks lost the border, they fought in the villages, and when they lost the villages they fought in the mountains.[24] The pathetic sight of today's Greeks rioting in the streets, throwing Molotov cocktails into bank buildings and burning innocent

[23] It's fine for Simpson-Bowles, the Gang of Six, and others to show that entitlements need to be cut and taxes increased. The trouble is that these ideas aren't *implementable*. Until someone shows us how to get from here to there, we can safely consider that no solutions are on the table.

[24] Many historians believe that the plucky Greek resistance to the Axis armies changed the course of the war. When the Italians were pushed back by the Greeks, Hitler was forced to divert German troops to help get the job done. Ultimately, this delayed the German invasion of Russia by about a month. A month may not seem like a long time, but when the Russian winter is coming on, it's an eternity. If the Greeks had simply rolled over, and if Hitler had captured Moscow, and if the Axis powers hadn't had to fight a two-front war – well, better not to go there. By the way, if this history seems too dry, you might look into the terrific fictionalized version of the Greek resistance in Alan Furst's *Spies of the Balkans*.

women alive, all in a futile attempt to continue to retire at age 50, tells us everything we need to know about the destructive power of failed wealth redistributionist policies.[25]

Wealthy families everywhere worry incessantly and with good reason about the challenge of raising productive, disciplined children who are outwardly focused on the needs of others. While it's a bit of an exaggeration, it's useful in assessing the scope of the challenge Europe faces to view the Europeans as the entitled, self-absorbed, feckless children of their wealthy societies. They lack a plan for moving forward, but even if they had a plan they seem to lack the character required to get it off the dime. And it's not just Greece, Spain and Portugal: in Italy, the relatively productive north has subsidized the sloth-like south for many decades and has now been milked dry, while France would look very much like Italy if it weren't for its small but productive populations of Jews and Huguenots.[26]

It's possible to imagine a world – possibly cheerfully inhabited by our grandchildren – in which wealth redistribution means moving money from the rich and middle classes to the poor, where the twin sorrows of human misery and lost human potential loom like neon indictments of the wealthy West. But it isn't possible to know how we're going to get there or when it's going to happen. Political incoherence is everywhere, and the implications of this for the United States – Europe isn't the canary in the coal mine, it's the gorilla in the kitchen – are many and profound.

Which raises the interesting question of how we should be investing our capital in such a world.

❖ But, First, A Note About Germany

Our readers have no doubt noticed that many of our comments about "Europe" don't seem to apply to Germany. It's certainly true that Germans appear to be harder working, thriftier and more fiscally disciplined than the rest of Europe. But there are some serious issues here.

The first is simply Germany's history. Try as they might, neither Europe nor the rest of the world is likely to allow the Germans to dominate Europe again. Thus, whatever the merits of the

[25] In his recent book, *Boomerang*, Michael Lewis refers to Greece as a country in "total moral collapse."

[26] Nearly a decade ago, long before the current crisis, the decline of France in particular but more broadly of Europe in general was described by Charles Gave in *Des lions menés par des ânes: Essai sur le crash économique (à venir mais très évitable) de l'Euroland en général et de la France en particulier*. [Approximately, "Lions led by donkeys: Essay on the economic crash (coming but certainly avoidable) of Euroland in general and France in particular."]

German prescription for the rest of Europe (austerity, fiscal discipline, firm central oversight), it isn't likely to be adopted by countries with long and dreadful memories.

More practically, the German export-led economic model[27] is simply not adoptable by Europe, for the simple reason that someone has to buy the exported goods. If, somehow, all the countries of Europe decided to become export-driven economies, they would all collapse at once – including Germany.

❖ If Solving the Mess Isn't Your Department, Can You At Least Suggest How We Ought to Invest Our Capital in the Meantime?

Yes. As we see it, there are only two possible outcomes to the mess the Western democracies have gotten themselves into:

(1) This is the end of the Western democracies, at least in terms of dominating the world economically, militarily and culturally. More vigorous nations, such as China, India, Brazil and Russia will soon rule the world.

(2) The Western nations will, slowly but surely, get their acts together, and we'll be back on solid ground again.[28]

If you believe in (1), you should invest all your money in emerging market stocks (and bonds) and relax on your back porch while your portfolio rises and the West sinks.

If you believe in (2), as we do, one of three things will happen:

(A) The Western governments will eventually take concrete steps to rein in spending and bring down debt. (We can think of this as analogous to Reagan and Volker taming inflation in the early 1980s.) When they do, you should move to a position well above your targets in risk assets.

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[27] Exports account for almost 50% of German GDP, versus less than 30% for the US and most other developed countries. In absolute terms, only China exports more than Germany. For a scathing look at German hypocrisy toward the rest of Europe, see our blog at www.Summitas.com/blogger/gregory-curtis.

[28] A third possibility would be for the Western nations to repudiate their debt and start over. We think this is likely to happen at the fringe, but not at the core.

(B) The West will muddle through, never really taking conclusive action, but managing to stave off collapse. In this case, equity multiples will gradually decline into the single digits, at which point you should move to a position above your targets in risk assets.

(C) The Eurozone will collapse, precipitating a global crisis that will cause equity prices to plunge to levels not seen since the mid-1970s – or maybe the early 1930s. This will be a catastrophe for the world, but will offer investors a once-in-two-lifetimes opportunity to buy stocks at subterranean pricing.

In the meantime, most investors should remain positioned close to their targets in risk assets, because (a) as noted below, equity multiples are not outrageously high, and (b) we could be wrong.

The beauty of (A), (B) and (C) is not that those strategies will maximize your gains, but that they will help preserve your capital until it's possible for significant gains from risky assets to become likely again. And at that point you will have the dry powder required to back the truck up. Optionality matters.

Regarding specific market sectors, here are our thoughts. We begin with the happy observation that global equity prices are not wildly out of line with historical norms. (If prices were at levels seen in, say, 2000, our views would be very different.) Therefore, even if matters go badly in Europe, there is less far to fall and this is important: avoiding huge losses is crucial to growing your capital.[29]

Our specific thoughts, which as always have a short shelf life (this is being written in early 2012), are as follows:

- Underweight the Eurozone, just in case.
- Overweight hedge, both long/short (where managers can be nimbler) and absolute return-oriented (which has less correlation to the long equity markets).
- Buy high quality, high dividend-paying, large cap companies. You can almost never go wrong owning great multinational firms at attractive valuations. Think Warren Buffett.

[29] This is the concept of "variance drain," a crucial but often-overlooked aspect of investing. Downside variability is especially devastating: if you are up 50% in one year and down 50% the next, you are still down 25%.

- Avoid sovereign debt in the developed economies, including the US, where yields don't compensate you for the risk of rising rates. Buy high quality municipal bonds and corporate debt. High quality high yield (say, B- through BB) looks interesting, as do bank loans, which are higher in the capital structure and boast floating rates.
- Maintain a core position in real assets, given that inflation is already an issue in the emerging economies and that the developed economies will likely need to inflate their way out of debt.
- Private equity/venture is almost always interesting for taxable investors, given its deferred long term gain treatment and the opportunity to invest alongside our most entrepreneurial sector. But beware of bubbles like the one that formed in the mid-2000s when more than 100% of private equity returns came from leverage.
- Be alert for opportunistic trades. High volatility and political and/or regulatory interference with capital markets usually result in an abundance of interesting investment opportunities.

❖ Summary

As this is being written (in early 2012), everyone's attention is riveted on Europe. And rightly so, since what happens there is very likely to affect the already shaky global economy in a powerful way. Will a major European bank go down, precipitating a global banking crisis? Will a major European economy default on its debt, sending Europe and probably the rest of the world into a double-dip recession or worse? Will Europe throw in the towel and re-atomize into something that looks like the Europe of the 1980s?

These are urgent questions, of course, but as we've tried to show at great length in this paper, Europe's immediate problems are only the symptoms of far deeper maladies. If Europe somehow navigates its current shoals, it can then turn its attention to the entitlement tsunami that is about to inundate the Continent.

But the problem is even worse: whatever steps Europe takes to deal with the immediate crises of bank and sovereign insolvency are very likely to make the already Gordian long-term challenges even more intractable. For example, what the European states need more than anything else is vigorous economic growth, but what they are getting is more austerity. What the European banking system needs is to get out from under its crushing debt load, but what it is getting is more debt.[30]

Still, judged according to its original goals the Great Experiment in Europe has been an extraordinary success. Never in human history have so many wealthy countries coexisted in so small a geographical space for so long without warring with each other. The Europeans have carved out lives that are in many ways enviable, less hyperkinetic than our own, more humanistic and less market-driven. There are thousands of places in Europe that cannot be encountered without an immediate attack of *coup de coeur*.

But all this lies endangered. The danger is Europe's and the world's, and the danger puts our capital at risk. Understanding the scope and depth of the problem and investing accordingly is the best we can hope for.

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[30] In late December, 2011, the European Central Bank lent the European banks $638 billion on three-year terms.