



The Pension Problem

by Craig D. Hafer, President

As we enter a new year, there is a sense of optimism in the stock market and U.S. economy that has not existed for several years, if not decades. While the economy chugged along, having its ups and downs, many pundits had been quick to express their views that the best of times for the United States were in the rear-view mirror. Seizing this sentiment, hedge funds and investment firms promoted investing overseas, or worse, getting completely out of stocks. While there was reason for concern, we felt that there was an argument for being cautiously optimistic about stocks, especially those with growing dividends!

If there was a “black swan” moment of the twenty-first century so far, it was the United States becoming the largest energy producer in the world. The best way to appreciate the significance of this is to watch the video of President Jimmy Carter’s April 18, 1977 televised speech, when he sat the nation down for “an unpleasant talk” to discuss the greatest challenge facing the nation, a problem that he claimed would “get progressively worse through the rest of this century” and rivaled war as the biggest threat to future generations: the shrinking energy reserves. Today, the U.S. is the largest producer of oil and gas. As opposed to shrinking supplies, we now have an oversupply. Oil prices have plummeted to a five and a half-year low of under \$50 per barrel, and Saudi Arabia is trying to retaliate by keeping output high, hoping to make extracting natural gas and oil in the U.S. cost prohibitive. This has only exacerbated the glut of oil and natural gas in the market.

While lower energy prices are a welcome sign for the overall economy, they will present a challenge to alternative energy. Higher oil prices (combined with government support) enabled the United States to raise its use of renewable energy to 12.9% in 2013, a 45% increase over the prior decade. The growth of alternative energy helped lower production costs of solar panels, and made the cost of electricity from solar competitive with that of electricity when oil prices were higher. As oil prices fall, alternative energy will need to either become more efficient, or seek renewed government support.

– continued



WINTER / 2015



WALSKY

INVESTMENT MANAGEMENT

The reversal in energy dependence on the Middle East highlights a topic that we have been discussing in our letters for the past several years. Our economy is often shaped by events that were not predicted. The fact that the U.S. is no longer dependent on the Middle East for energy presents a unique situation that has not existed during our lifetime. Our biggest economic challenges may not be caused by external influences (such as OPEC in the 1970's), but instead by internal issues (such as government debt and unfunded pension obligations).

With the economy on firmer ground, the United States needs to address its numerous pension obligations and budget deficits. In 2012, it was estimated that “unfunded pension liabilities add more than \$2.5 trillion to America’s \$16 trillion federal debt and \$2.8 trillion state and local debt.” While the problem has continued to grow, the political will to address pension liabilities and government debt has remained weak.

The current problem with government pensions is that most are not fully funded and are therefore adding to budget deficits at the local, state and federal levels. As pension costs increase, governments must either raise taxes to fund them, or cut costs in other areas; this has been the debate in our government, with most opting not to increase taxes, but instead reduce spending in other areas of their budget. School classes get larger, music programs are cut, roads don’t get improved or plowed as well, police departments shrink, and so on. While voters have favored not increasing taxes, the tradeoff is that as long as the pension obligations grow at current rates, the quality of services one gets from their government will decrease. Worse yet, these obligations are often funded with debt that our children or grandchildren will need to pay. This shift in spending will lower the overall long-term growth of the U.S. economy, and is a very short-sighted economic plan that will need to be rectified at some point, as our schools and infrastructure fall into disrepair. While it may be painful to address these pension problems, the sooner we do it, the less of a burden it will be for future generations.

Another unforeseen change that is shaping our economy is the evolution of globalization. At the outset of this century, many believed that with globalization, the United States would lose ground as an economic powerhouse. With advances in technology and transportation, companies could manufacture or provide services in other parts of the world as easily as in the U.S. What this theory failed to take into account is that in many parts of the world, doing business carries with it a great political component. India, China, and Eastern Europe may all provide cheaper labor, but they also have significant political challenges, similar to those faced in the U.S. and Western Europe during the Industrial Revolution. It may take decades for these nations to fully address their issues of pollution, corruption, women’s rights, lack of property rights, etc. There is a risk to investing in these countries that few appreciated just a few years ago. Investors have begun to realize these risks, and the dollar has catapulted to an 11-year high, as foreigners seek the safety of the greenback.

As the United States enters a new year, it is the world’s largest economy and the largest producer of food and energy. It is also the wealthiest nation in the world, with resources too numerous to mention. If the nation were a company, it would be Microsoft, GE, IBM, and P&G all rolled into one. The challenges of global warming, pension costs, and budget deficits are real, but ones that can be addressed over the next several decades. Gridlock has too often been accepted as an excuse to do nothing. Today’s problems require new and innovative solutions like those we have explored in prior newsletters letters, from people such as Diane Coyle, Erik Brynjolfsson, Andrew McAfee and Dan Ariely, and many more that we will explore in 2015. While it is natural to look to the past, the reality is that the future for the United States is promising. If and only if we have the political will to make it so. 🙏