

Summer 2010

The Age of Austerity

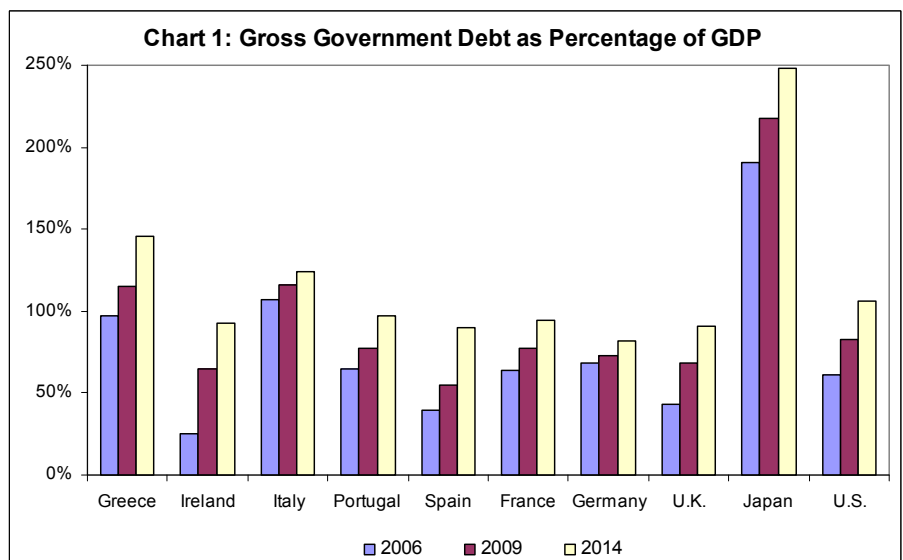
The talking heads on TV are using the term “austerity” a lot these days, often in connection with the economies of the PIIGS. As in, “Portugal, Italy, Ireland, Greece, and Spain need to tighten their belts and take *austerity* measures.” Austerity will be coming to a neighborhood near you – if it hasn’t already.

Let’s look at the “Club Med” countries and work our way west. Greece is the poster child for living beyond one’s means. Enticed by the low interest rates offered via poor underwriting and its European Union (EU) membership, Greek government officials went on a spending spree. Times were good, promises were made to public employees, and global competitiveness didn’t matter. How times change.

It took a 110 billion-euro rescue package coordinated by the International Monetary Fund (IMF) and fiscally responsible EU members to backstop Greek debt. To prevent bond vigilantes from preying on other fiscally weak countries such as Spain, Portugal and Italy, the IMF and EU also established a 750 billion-euro European Financial Stability Facility.

How much protection that will provide weak EU economies and the euro itself is something that only time will reveal.

The rescue package for Greece is contingent on aggressive cuts to government spending, enraging its spoiled populace. But Greece is not alone in running out-of-control budget deficits. Other developed countries also have a large debt burden – Chart 1 illustrates the trajectory of gross government debt as a percentage of



Sources: BCA Research, International Monetary Fund

gross domestic product (GDP). When the percentage of debt to GDP approaches 100%, the lenders of debt begin to get worried. They got very worried with Greece.

Any country that does not meet its borrowing needs from its citizens cedes some control of its financial destiny. Realizing this, more countries are beginning to take serious steps to curb their debt so that they don't end up like Greece.

The advanced economies attending June's G20 Summit committed themselves to fiscal plans including a 50% or greater reduction in their deficits by 2013 and stabilization or reduction of government debt-to-GDP ratios by 2016. The implication is that the G20 members have agreed to global fiscal responsibility and that we should not expect significant stimulus packages in the future.

Emerging-market countries aren't in this dire situation, and we expect their growth to continue. For developed countries, however, austerity is becoming the norm, with weaker economic growth.

How Did We Get Into This Predicament?

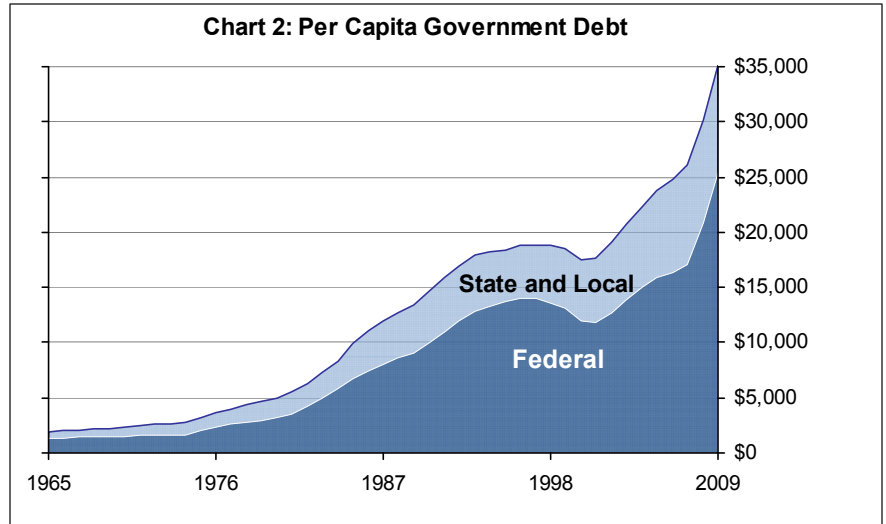
Here in the US, we don't have an elaborate social safety net like the other countries shown in Chart 1. The overextended fiscal condition of today's households and local, state, and federal governments is often cited as the cause of the credit crisis. But this is a crisis that's been decades in the making. Like other members of the global developed economy, we were enticed by low borrowing costs, and we thought strong economic growth was sustainable.

Since 1970, according to inflation-adjusted figures from the Heritage Foundation, household incomes have increased 29% versus a whopping 242% increase in total federal spending.

At all levels, we made decisions based on what is now called the Goldilocks economy, characterized by sustained moderate economic growth, low to moderate

inflation, and a market-friendly monetary policy that kept interest rates down.

In the real world, however, that couldn't go on forever. And now, added to whatever personal debt each one of us has, our per capita share of federal, state and local debt is \$35,000 (see Chart 2).



Source: Bloomberg LP

One Thing Leads to Another

Essentially, the growth of an economy is based on four factors - consumers' willingness and ability to spend, the government's willingness and ability to spend, the private sector's willingness and ability to invest capital, and the amount by which our exports exceed our imports.

Consumer spending was the most important factor in US economic growth over the past decade. The value of our investments kept rising. Home prices could only go up, rates were low, lenders were willing. Why not refinance the house to pay for the children's education, take the family to Hawaii, lease a luxury SUV, upgrade our wardrobes? Well, that's all over. Many homes wouldn't support tighter loan-to-value requirements even if the owners *did* want to refinance.

It's not that Americans have forgotten how to shop, but they're nervous. Unemployment rates are high, most people's net worth has fallen, and saving rather than spending has come into vogue. We don't believe

that consumers are going to keep contributing more than 70% to the GDP.

So What Will Take Up the Slack?

In order for the economy to really grow again, one of the other three components has to make up for the consumer spending shortfall. The federal government has embarked on an aggressive spending spree including stimulus to revive the economy, and some of that money has passed through to the consumer (think of homebuyer credits, car credits, extended unemployment benefits).

Putting extra money into consumers' hands through these "transfer payments" has temporarily masked the decreased contribution that consumer spending will contribute to the GDP. Removing or reducing these transfer payments will reduce economic growth.

As for the federal government's other contributions to GDP? We've entered the age of austerity. And the contributions from state and local governments? Almost all of them are in serious financial trouble and federal stimulus is waning. Unlike the federal government, they have to balance their budgets without printing money.

Capital investment has troughed and is slowly increasing its contribution to GDP, but it has a long way to go to reach the 15% that it used to contribute.

As for the export/import balance? Exports are fighting a stronger US dollar and a depressed world economy, and our appetite for foreign goods continues to lead to a negative trade balance.

Gross Domestic Production =
Private Consumption +
Gross Investment +
Government Spending +
Net Exports

For these reasons and more, we expect near-term GDP growth to be quite sluggish.

All the developed economies are facing similar problems, but we think they will muddle through the

mess, make the necessary difficult decisions, and emerge in stronger condition. Even on our side of the Atlantic, we're beginning to see recognition of the fact that runaway spending must be contained. State and local governments have no choice but to rein in spending, and a pay-to-play budgeting mentality is becoming more prevalent at the federal level.

About the author: Richard Long, CFA, is responsible for the implementation of Contango Capital Advisors' investment strategies and manages the due diligence team. His background includes analytical research and positions with private client groups.

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Good News About Buying and Selling Small Businesses

Big corporate transactions make the headlines and there has been a dearth of them this year. This may cause distress in Goldman Sachs and the other large investment banks, but these headlines mask a completely different trend for the markets in which our clients operate. In fact, the market for buying smaller companies has been robust, and the prices paid have significantly improved compared with the depths of the financial crisis in 2009.

The statistics are very compelling. Sales of businesses valued at \$1 billion and below (yes, we know, but that is the basis on which nationwide data were collected) were up 72.7% for the first five months of 2010. Moreover, the median price paid was 8.2x cash flow for the six-month period ending May 2010, versus 7.2x cash flow during the June 2009 through November 2009 period. (Cash flow here is defined as EBITDA, or earnings before interest, tax, depreciation, and amortization expenses.)

This upturn has been driven by a variety of factors:

- Private equity firms have between \$500 billion and \$850 billion in funds that they have raised and now need to deploy;
- Business owners are somewhat more motivated to sell prior to anticipated increases in the capital gains tax rate;
- Large corporate buyers have a lot of retained cash and are looking for “bolt-on” acquisitions of small firms that can augment their revenues and leverage their operations.

Again, contrary to headlines, smaller businesses are starting to benefit from a number of positive economic developments. Banks have raised new capital and are successfully working out their losses from the financial crisis. They are now keen to do more business lending. Capital spending and hiring by larger corporations has improved in recent months. World trade has picked up over the past year as has confidence among individuals and business leaders. The US recovery now under way is unlikely to be robust by historical standards, but it should be strong enough to improve the profitability of small business over the next year.

About the author: Greg Chiampou heads Contango Capital Advisors' Private Business Financial Strategies division. He has more than 20 years of experience in investment banking, capital markets, and private equity investments.

Time to Sell Your Business?

If you are considering selling or transitioning control of your business over the next five years, now is the time to put the planning wheels in motion.

Step 1: Sketch the big picture

Business sales are complex. Before you start, you should have a sense of where you want to go. Will you retire? Start another business or career? You'll need to calculate the price of those dreams. What price can you realistically get for your business? Can you do anything to add value before the sale or help its transition to new owners? What are the alternatives?

Step 2: Staging the business for sale

If you have ever sold a residence, you probably improved and “staged” the home to make it more appealing. Selling a business is similar. You need to tidy up to attract a good buyer and get the best price. But the business equivalent is a bit more involved. You may need to restructure the entity, or eliminate some business risks, or re-visit your business growth plan. And you will need to assess how viable the business will be without your ongoing involvement.

Step 3: Accounting for emotion

Even in the most harmonious families, serious conflicts can arise around the sale of a business. Add in the competing interests of employees, community, partners and your own personal goals, and emotions can run high. A well-conceived plan can address family and estate issues, as well as employee incentives, to make your transition that much smoother.

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