

Investment Commentary—January 2010

Developments in the U.S. economy have remained consistent with the scenario we suggested two quarters ago: a gradually accelerating recovery in the second half of 2009 and early in 2010, which loses steam in the second half of 2010 as fiscal stimulus wanes. To review by now familiar ground, the engines of the current recovery are very vigorous monetary and fiscal stimulus together with inventory rebuilding. By the second half of 2010 two of these engines will sputter as stimulus expenditures shrink and inventory rebuilding is completed. The Fed will keep rates low all year, but will terminate its program of buying mortgage-backed securities, so even the monetary engine will shift into a slightly lower gear in the next few months.

Driven by inventory rebuilding and healthy exports, the recent vigor in the manufacturing sector has been notable. Goldman Sachs, whose economics group we think is as good as any on or off the Street, just increased their q4 GDP forecast to a whopping 5.8%. This tangible momentum in the economy will be critical six to twelve months from now when stimulus withdrawal, a cresting wave of foreclosures and state and local austerity budgets all exert pressure in the other direction. Fortunately, the current strength seems robust enough to carry the economy through the year and into 2011 without a double-dip recession. Still, growth will almost surely decelerate in the back half of this year. The unemployment rate may hover for a protracted time in the vicinity of 10% and the glimmers of a robust recovery evident now will fade. For several quarters or more the economy will languish in a netherland somewhere between recession and real recovery.

Looking beyond the next year or two, we're optimistic that foreclosures will run their course, excess housing inventory will be worked off, consumer balance sheets will be delevered (or largely so) and a robust recovery will finally take hold. Best we can tell, this makes us considerably more sanguine than the average financial/economic pundit, who seems convinced that one or more looming maladies cast an endless pall over the future prospects of developed economies. The maladies cited range from asset bubbles to inflation to an anticipated collapse of the dollar to excessive government debt.

Asset bubbles are said to be developing as a consequence of exceedingly low interest rates. Speculators are borrowing dollars cheap and pouring money in non-dollar denominated assets. This, economist Nouriel Roubini (who famously

foretold the bursting of the housing bubble) assures us, is creating the mother of all asset bubbles. While this dynamic is certainly in place, the resulting asset bubbles are modest thus far. And, in any case, one of the lessons of the last ten years is that bursting asset bubbles (think tech stocks) are not nearly as painful as bursting credit bubbles (think subprime mortgages).

Concerns about inflation and the dollar are tied up with concerns about excessive government debt, which we discuss at length below. It's true that massive federal deficits, along with the dramatic expansion of the Federal Reserve's balance sheet, set the stage for inflation down the road and cast a cloud over the dollar. Tepid growth over the next couple of years will ensure prolonged spare capacity in the economy, but eventually growth will pick up and the Fed will have an inflation fight on its hands. That said, Bernanke and his eventual successor know this and have the tools to wage the fight. Further, recall that the classic mechanism for igniting a debilitating bout of inflation is a wage-price spiral where labor, anticipating future inflation, pushes for increasingly aggressive wage hikes, which further fan inflation's flames. But a wage-price spiral requires reasonably tight labor markets and a heavily unionized workforce, neither of which are in the offing. As for the prospects of a collapse in the dollar, we'd be more worried if there were a plausible alternative currency. The euro faces equally challenging debt problems (compounded by the lack of a central fiscal authority) and daunting demographics (low birth-rates that may eventually lead to population declines and economic stagnation). The Chinese yuan may some day become the world's reserve currency, but realistically that sort of role would seem to be decades away.

The one point where we sympathize with the pessimists is government debt, which is a significant problem not only in the U.S., but also in the U.K., Greece, Spain, Ireland, Portugal, Italy and Japan. While the U.S. is not alone, the prospects of a U.S. debt crisis are clearly the most ominous, so let's focus there and begin with some history. U.S. government debt first exploded during World War II, peaking as a percentage of GDP in 1946. This debt shrank relative to the economy in the 1950s and 1960s due to rapid economic growth and balanced (more or less) budgets. Deficit spending became the norm beginning in the late 1960s, but debt relative to the economy was stable until the 1980s when tax cuts led to large budget deficits. The vigorous economy and prudent fiscal policy of the 1990s brought debt to GDP ratios down significantly. In the early years of the new millennium, taxes were cut further, spending grew rapidly and the debt began to grow again. By one measure, "debt held by the public," growth in debt heading into the Great Recession was relatively modest. This is misleading though, as it excludes debt held by the Social Security and Medicare trust funds. The huge surpluses in the trust funds are an artifact of baby boomers dominating the workforce and will rapidly dwindle when baby boomers retire. By contrast, "gross federal debt," which includes the trust funds, grew rapidly between 2001 and 2008. In fact, nearly three decades of fiscal profligacy (save for a brief period in the 1990s) caused gross debt

relative to GDP to more than double from 1982 (32.6%) to 2007 (65.6%). We entered 2008 one financial crisis away from a huge debt problem.

When the economy fell off a cliff in the fall of 2008, government revenues plummeted. Further, in an effort to stave off a depression, the Obama administration pushed through an \$800 billion stimulus package. In one year, gross debt to GDP exploded from 70% to 90%. While there's no magic number, anything north of 100% is thought of as very dangerous territory. On a gross debt basis, we will probably hit 100% some time in the next couple of years. Debt held by the public (which is more important in the short run) is a much more manageable 60%, heading towards 70% within a year or two. As the trust funds begin to be spent down though, that figure too will head steadily toward the danger level of 100%. The risk at these levels of debt is a vicious cycle in which creditors (read China) begin to demand higher interest rates, which itself increases government expenditures, leading to higher interest rates, etc.

The Obama Administration can with some justification claim to be the victim rather than the perpetrator in this tale. It's entirely possible that the recession would have been much worse without the stimulus package, in which case debt conceivably would have been higher without the intervention. No matter. The levels of U.S. debt now demand attention. Some in the Administration argue that it's too early to focus on deficits because the economy is still fragile. Fragile it is, but the conclusion hardly follows. The most rapidly growing components of federal expenditures are Social Security and Medicare. The surest way to fix our debt problem would be to increase the eligibility age for these programs. If Congress voted tomorrow to increase the eligibility age by five years, but phased it in with the first increases effective five years from now (with apologies to my sixty year-old clients), the impact on long term debt forecasts would be significant. That sort of bold action would be welcomed by creditors and provide plenty of breathing room for any additional steps required to stabilize debt. And, with implementation five years down the road, there would be no adverse effect on the economy.

Of course, we're not holding our breath that Congress will take such dramatic action any time soon or that the Administration will request it. It may be that the situation has to get worse before policy makers act (threats of a downgrade by the rating agencies may be the ultimate precipitant to action). More optimistically, voters may take matters into their own hands.

Government deficits and debt are bubbling up as a major issue for the 2010 midterm elections. In 2002, Dick Cheney said that "Reagan proved deficits don't matter."¹ Investors should be very pleased if voters demonstrate the opposite in November.

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¹ Former Treasury Secretary Paul O'Neill recounts this in his autobiography. It's not clear whether Cheney was speaking about economics or politics. For rhetorical purposes, we take it to be the latter.