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# The Road Ahead

Global equity markets have recovered about half their losses since 2007 amid signs of slowdown in layoffs and improvement in earnings, as forecast by most analysts. However, most ordinary people have a different assessment of the economic environment. For many, the realities of the downturn have had a major impact on lifestyle and expectations about the future. Notably, the very rapid rise in debt relative to assets and income has had a major effect on attitudes and the economy. Debt, despite record low cost of money, has become burdensome, especially as baby-boomers look to retirement and real disposable incomes are falling. Over-indebted balance sheets can be seen among many households, private businesses, pensions, as well as Federal, State, and local governments. These deficits and shortfalls have many causes, but many assumptions regarding the financing of those obligations are being challenged.

So while we welcomed improvement in financial markets in 2009, we do not see the economy as out of the woods. Instead, we expect ongoing challenges to the domestic economy in the aftermath of an asset and credit bubble of historic proportions. This fact makes prospects for recovery markedly different from past recessions, where preceding levels of malinvestment and indebtedness were much smaller. We also see greater burdens coming from taxation and regulation acting as an unwelcome headwind to recovery in the United States just as falling tax and regulatory burdens provided a pleasant tailwind in the past. For this reason, the nascent recovery is more tenuous and fragile than past recoveries.

## Challenges Remain

The major challenges to the economy are now structural in nature given high levels of debt and historically low levels of taxes and interest rates. Consider for a moment that from 2000 to 2007, the amount of debt incurred by U.S. households was of unprecedented proportion. The total debt held by Americans ballooned to $14 trillion from $7 trillion in just seven years. At the same time, the percentage of equity in real estate owned by Americans fell to 36% of the average home's value from 66% back in the 1980s. All of this happened as 30-year conforming mortgage rates fell to 5% from 12% and rates on 3-Month T-Bills fell to 0% from 8%. But that is not all. Down payment requirements for getting a mortgage are now 3% for some government-guaranteed mortgages compared to a more traditional 20% requirement in years gone by. All of this produced the fastest rise in American household indebtedness ever seen, along with a doubling of home prices as seen in the S&P 500 / Case-Shiller 10-City Index from 1999 and 2005. The drumbeat of continuous private sector credit creation ended abruptly in 2009, however, as statistics now show that the private sector (households, businesses, financial companies) are reducing debt balances (by pay down, write-down, or default) at an annualized rate in excess of $1 trillion. Nowhere in this process was a serious effort undertaken by the Federal Reserve or Congress to restrict access to credit or raise the cost of credit to borrowers in order to moderate the expansion of credit.

In the aftermath of the collapse and taxpayer-funded rescue, there are loud calls for additional regulation with little accountability or responsibility directed at the Federal Reserve itself. Before an address to the American Economic Association this week, Ben Bernanke insisted that it was failed regulation, rather than the Fed's role in setting monetary policy, that produced the housing bubble. He argued that low interest rate and rapid credit expansion was justified during the boom phase because consumer price inflation remained in check throughout that period. Had he included asset prices into his framework for assessing inflation, he might have reached a different conclusion.

Hence, the Fed's willful blindness to asset prices during booms and eagerness to reflate during busts is directly in opposition to the idea of monetary policy designed to soften economic booms and busts using counter-cyclical policy. Instead, the Fed is complicit in amplifying the cycle. This is why we believe it is increasingly important to incorporate analysis of credit into portfolio decision-making and why we have heavily weighted credit indicators in our asset allocation decision processes.

## Working Off Bad Investments

We have established the root causes of the crisis and downturn in debt and credit. We also see the Fed as playing a central role in controlling this process through their execution of monetary policy. Now we want to emphasize that there is a direct tie-in between the size of the bubble, the harshness of the downturn, and the amount of malinvestment in non-economic assets that have yet to be unwound and recognized. For example, many mortgages made in recent years were made with only the thinnest collateral and made to purchase assets at prices bearing no reasonable connection to historic valuations. So far, the decline in value of those assets and the rise in non-performing loans have resulted in over $1.7

trillion of recognized losses at financial institutions worldwide, according to Bloomberg data. We expect that losses will re-accelerate again in 2010 as the Fed backs away from direct purchases of mortgages, tax incentives are set to expire, foreclosures resume, and as a second wave of mortgage resets on adjustable rate mortgages are set to take effect.

Closer to home, there are already one-in-three mortgages that are worth more than the estimated value of the property and one in seven mortgages are behind in making payments. Thus the euphoria from the distorted asset prices has turned to despair for many in the form of lost homes, lost jobs, lost income, and lost share in the "American Dream." Prior to the bubble, the unemployment rate was below 5% and the average equity in a home in the U.S. was near 60%. In the aftermath, the unemployment rate has risen to 10% and the share of equity in a home is closer to 30%. Thus the illusion of real estate wealth has been dispelled just as the illusion of stock market wealth was dispelled years earlier. However, today's low interest rate environment and government guarantees on private debts have become the basic tools for restarting the process once again. We see the early signs of this in the various indicators we track on credit, the domestic economy, and foreign trade.

## The Cost of Intervention

Most importantly, the challenges to the economy are long-lasting and structural in nature and government resources are not unlimited. The legacy of unfunded obligations, deficits, and debt arising from non-productive investment will provide a headwind into 2010 and beyond. We recognize that much of the improvement seen in 2009, and expected for the first half of 2010, has been financed by the public sector. For example, the backstopping of increasingly risky mortgages and other forms of credit with taxpayer dollars has reached extreme levels; while the commercial banks and issuers of asset-backed debt have shed about $1 trillion in assets from their books in the past year, government-backed debt instruments have increased by a similar amount. The sum total of loans, backstops, guarantees, and equity investments by the government has been over $10 trillion, according to Bloomberg. Since it is not feasible for this level of support to continue without massive tax and inflation implications later, we see the government set to begin a withdrawal in 2010 lest it begins to call into question its relative creditworthiness. Given the unprecedented amount of intervention, the effects of the withdrawal of such intervention also have no precedent.

Leaving aside the potential losses at the Government Sponsored Enterprises related to bad mortgages for the moment (by the way, Congress recently removed the cap on such losses), the direct deficits that we are now incurring have the ability to raise interest rates, and import prices later. This is because higher deficits have the potential to cause investors to demand a premium to invest in bonds of highly indebted countries. According to IMF data, the United States' deficit as a percent of GDP is expected to climb to 6.7% in 2014 from 2.8% recorded in 2007. Similar increases are expected for Japan and the United Kingdom. By contrast, the average emerging market economy is expected to have deficits running at only 1.3% of GDP by 2014 and the average country among the G-20 running at 3.7%. There is no free ride in economics and

unchecked deficit spending must eventually be paid for. Higher taxes on wages, property, or money can not be put off indefinitely, and the uncertainty about the timing and size of these burdens impedes, rather than helps, the investment in real productive capital that the economy so badly needs right now.

## Conclusion

So you can see that the ongoing challenges to the economy are not only long-lasting and structural in nature, but also the result of three main factors: excessively easy money before the downturn, malinvestment in non-economic assets through the boom years, and losses that inevitably follow. The global equity market rebound that we saw in 2009 has been sufficient to recapture about one-half of the losses in those equity markets, and this has certainly helped improve balance sheets. So we are happy to see that markets have responded to government intervention in the past year, and we have participated in the improvement by raising our allocation to risk assets in our portfolios. However, what comes next is crucial, because it is not yet clear whether the global economy can sustain recovery in the absence of support. Credit, and the Fed's management of the credit cycle going forward, will either create confidence in investors to make long-lived investment in capital or will produce additional, potentially more disruptive booms and busts.

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