

Shaping up

19 October 2009 | By Vanessa Drucker



Signs of an upturn are dished up but geopolitical uncertainties and the responses of policy makers are crucial to the outcome. Vanessa Drucker in New York examines the factors that will affect the shape of the economic recovery.



Every tendril of a green shoot engenders mounting optimism. Investors respond with intense rallies in equity and credit markets worldwide. Predictions for a second Great Depression have quieted, replaced by arguments over the probability of a V, L, W, U or some kind of squiggly shorthand-shaped recovery.

Central banks and governments must eventually devise exit strategies from their largesse of easy money and accommodation. They face a litany of potential missteps. Policy makers navigate between twin evils: tax or interest rate hikes threaten to destabilise any nascent recovery, and tip their economies back into recession, but sustained mammoth budget deficits will nurture inflationary expectations.

Warren Buffett, who says economies are settled on a “slow path to recovery”, warned in an August New York Times article that authorities must still deal with the dosages of monetary medicine, which “may be as ominous as that posed by the financial crisis itself”. A worrisome danger is that legislators opt for rising inflation, which is less likely to cost them votes than raising taxes or cutting social spending outlays.

Both the Federal Reserve and Bank of England are locked into a finely tuned balancing act. The goal is to reignite consumer demand and foster animal spirits, stave off treacherous feedback loops, and then switch off the spigot at the precise moment and at a suitable pace, to keep inflation at bay. The timing must be as impeccable as a mid-air acrobatic stunt, for if they get it wrong, second order effects could be sinister. It is extremely difficult to synchronise. No-one has any idea when the consumer will step up again. Few indications offer clues, beyond consumer sentiment surveys, which largely reflect a sugar-high of rising stockmarkets - and which could swiftly tumble again.

As governments extricate, they engage in a confidence game. If they withdraw too soon, and economies crumble, “confidence would be shot”, says Alan Madian, a director at LECG, a global consulting firm. He says it is easier to restore liquidity than confidence, especially the second time around.

On the other hand, if governments keep priming the pump (printing presses) they may end up by paying the piper with currency devaluation, at the very least.

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“Unchecked greenback emissions will certainly cause the purchasing power of currency to melt,” Buffett wrote. Even that sacrifice is not simple. “In the old days, we used to say, let the dollar go, pay back debtors with cheap dollars - problem solved,” says John Lekas, senior portfolio manager of the Leader Short Term Bond fund in Portland, Oregon. “But today’s

debtors include both the domestic public and foreign bond buyers, such as the Chinese, and we need them to keep financing us."

Alongside cheap money, the American government has provided direct stimulus in the form of tax rebates, spending projects and industrial support. "Stimulus may even be the wrong word. At this level of spending, stimulus becomes more of a behavioural concept," reflects Sharath Sury, Dean's executive professor of finance at Santa Clara University.

He says: "The government would have liked the consumer, with so much apparent free credit, to start spending on its own and change behaviour. The data has not borne that out." Despite some upticks in home sales, the number of foreclosures is rising, American unemployment stands at 9.8% and banks are hoarding money. "Consumption and investment spending will remain down, as government's 'conspicuous consumption' balances the traditional equation," Sury adds.

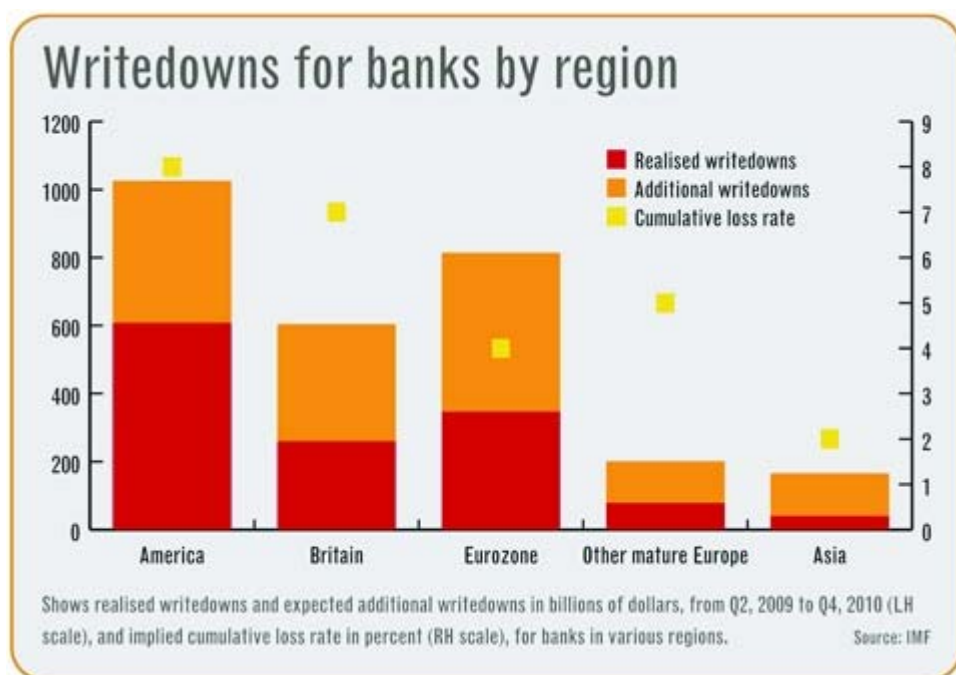
Many believe the stimulus binge creates an overhang, also known as kicking the can down the road. Housing and auto programmes are obvious examples.

First-time American home buyers enjoy an \$8,000 (£5,000) tax credit, but this is set to expire at the end of November. Although home sales have risen slightly over the summer, coming seasons will probably lose some of the tax credit's fillip. Cash for clunker discounts (car scrappage schemes), ostensible successes on both sides of the Atlantic, are already running out of fuel. After a buyers' spree, in September General Motors reported a 45% decline from last year, and Chrysler a 42% plunge. Buyers shift the timing of their purchases, bringing sales forward from, say, December to August, according to Chris Kiesel, portfolio manager at Oak Advisors, in Hilton Head, South Carolina. "It comes off future vehicle purchases, or comes away from spending in other sectors, like retail."

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Some other unpleasant adjustments are shortly coming due to aggravate the hangover. More than 60% of American corporate debt is scheduled to mature over the next four years, not to mention obligations of consumers, municipalities and government.

"Everyone will be competing for fewer investible dollars, like 500 people trying to get through a small door in 10 seconds," says Lekas. Recent well-meaning credit card legislation, enacted to protect consumers from exorbitant charges, simultaneously accomplishes a perverse effect, as companies deny or restrict credit to cash-strapped or indebted customers. Meanwhile, the residential real estate sector faces a wave of adjustable rate mortgage resets in 2010 and 2011, which will drain off more cash from homeowners' pockets.



Notwithstanding, corporate profits have helped fertilise the green shoots, by thoroughly beating extremely modest expectations. Shell-shocked analysts had already trimmed their estimates to the bone. More significantly, the improvement in margins resulted almost entirely from draconian cost cutting, with no increase in revenues. With top-line growth dead, margins threaten to shrink again. A cash-constrained consumer may force companies to slash prices, while at the same time, interest costs and costs of capital spiral higher.

Despite the recent resurgence in mergers and acquisitions (M&A) activity, heralded as a sign of recovery, consolidations also carry negative consequences. As companies hitch up, mergers will encourage them to sacrifice additional employees. When companies justify joining forces, citing synergies and cost cutting, the main expense they will shave will be personnel. For instance, if Kraft Foods succeeds in its bid for Cadbury, 20,000 people will lose their jobs, Lekas predicts. He even suggests that "we might actually see some American towns and municipalities merge as well".

The official unemployment toll ignores the impact on small business, which has no access to capital markets or even banks. "Mom and pop operations are now a major source of job losses, which is not fully represented in government data," says macroeconomist David Levy, who heads the Jerome Levy Forecasting Center.

When countries begin to unwind their support mechanisms, the economic landscape will be treacherous enough. Those dangers do not even take into account several exogenous shocks that could destabilise a system poised for a tentative recuperation. Levy worries that another round of financial sector problems could deliver the next wallop.

The most recent International Monetary Fund (IMF) Global Financial Stability Report, released on September 29, offers little comfort. The IMF estimates projected global write-downs at \$3.4 trillion, albeit an ostensible "improvement" from an earlier forecast of \$4 trillion. Most alarming, the organisation notes that more than half of these impairments have yet to be recognised, and banks will need to raise more capital. According to the report, European banks are in even worse shape than American institutions, having acknowledged only 40% of losses, versus 60% on the Yankee side.

Banks' margins may soon suffer from higher debt interest costs, higher deposit insurance premiums, regulatory expenses and elevated capital requirements. Commercial real estate and mortgage backed (CMBS) losses will prove especially troubling, with estimates for American losses in the sector ranging between \$350 billion and \$500 billion over the next three years. In the residential arena, default rates on prime mortgages continue to climb, despite several banks still holding back defaulted mortgages from foreclosure. Some newly relaxed Financial Accounting Standards Board (FASB) accounting guidelines are letting them postpone the day of reckoning, while revisions in mark-to-market reporting have injected balance sheets with arguably cosmetic improvements.

Analysts tend to factor out geopolitical risk from their projections, on the basis that these are unknowable or at least unquantifiable. While that approach has merit, it may be worth considering several political threats.

One factor to rattle financial markets is a new, post-Obama dynamic of foreign policy, so far unproven or tested under fire. "For the previous eight years of the Bush administration, we may have been too hawkish, but we were at least predictable. The allies looked at the US as a kind of big brother, with a club," Kiesel describes. Is America now ceding that good cop/bad cop role? If it does not take the lead on some problems, or is unwilling to bear traditional burdens, markets may have to revise some assumptions.

Kiesel highlights the imminence of an Iranian stand-off. "Iran has a time limit on its nuclear programme, and as each year goes by, we are moving closer to it," says Kiesel. He hastens to remind the difficulties of predicting an Iranian outcome, especially considering the ongoing civil unrest and reform movement within the country. "Russia seems to enjoy that Middle Eastern instability, since they don't see themselves as a target, and it in fact helps pay their bills through an oil premium."

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Indeed, crude oil could easily serve once again as a tipping point for the world economy. Last year, as its price raced up to \$147 a barrel, the price rise worked like a tax on consumer and industrial transportation. As the dollar weakens, oil priced in dollars, tends to move counter to the greenback. A further contractionary petro-shock could undo whatever benefits government stimulus has fostered, setting off another vicious cycle.

Suppose, however, we muddle through, and none of the above shocks comes to pass. Imagine that oil prices remain contained, and Iran reaches an acceptable compromise on its nuclear programme. Even then, in a best case scenario,

"people have become complacent in assuming the template for economic recovery will follow the same script as before," says Kiesel.

Will emerging markets ride to the rescue? According to Bruce Stout, senior investment manager at Aberdeen Asset Managers in Edinburgh, they are unlikely to accelerate as fast in the next decade as over the past 10 years, but their pace of growth will outstrip that of America and Britain. In 2009, they still exhibited savings and real income growth, albeit from a lower base. Size is key. Stout adds: "Ten years ago, China and India had little influence, because their economies were not large enough. Now China's is larger than the UK's. And if the Chinese walk away from Treasury markets, US bonds have had it."

Perhaps international trade will help stabilise the world, but even the rules of comparative advantage cannot entirely save us. It is no secret that over the past 50 years, manufacturing activity in both America and Britain has eroded. "We can't even assume our advantage in high-tech design will continue," Madian notes. "Emerging countries are graduating a significant number of highly trained engineers, and many foreigners educated in the West even now are choosing to return home."

"In a co-operative, rather than a zero-sum game, we are losing out relatively and likely absolutely," Madian continues. In theory, everyone produces where they have comparative advantage, to maximise welfare both globally and locally. But certain externalities still count, like the numbers of people who can only work as factory operators. If international trade drives those jobs away, it will be a significant burden on western governments to maintain those people. So we may obtain better goods more cheaply, but at a huge cost for society.

Stout is nonetheless quick to note that other areas of the world may grow, having escaped some of the worst consequences of the banking system excesses and mountainous debt. A report from McKinsey Global Institute (MGI) echoes that sentiment. The group predicts that mature markets will experience more sluggish growth, particularly because private debt and equity will slow, as households and businesses reduce debt burdens and corporate earnings revert to long term trends. Although MGI expects emerging markets to continue to expand, it concludes that elsewhere financial assets will grow at about the same pace as GDP - as they did 30 years ago.

Stout considers the structural problems in America and Britain: "Overindebtedness in both the fiscal and household sector will not disappear, but will take years to unravel. We have been living beyond our means for a long time and now face a future of below trend growth, as we pay down debt with increased savings."

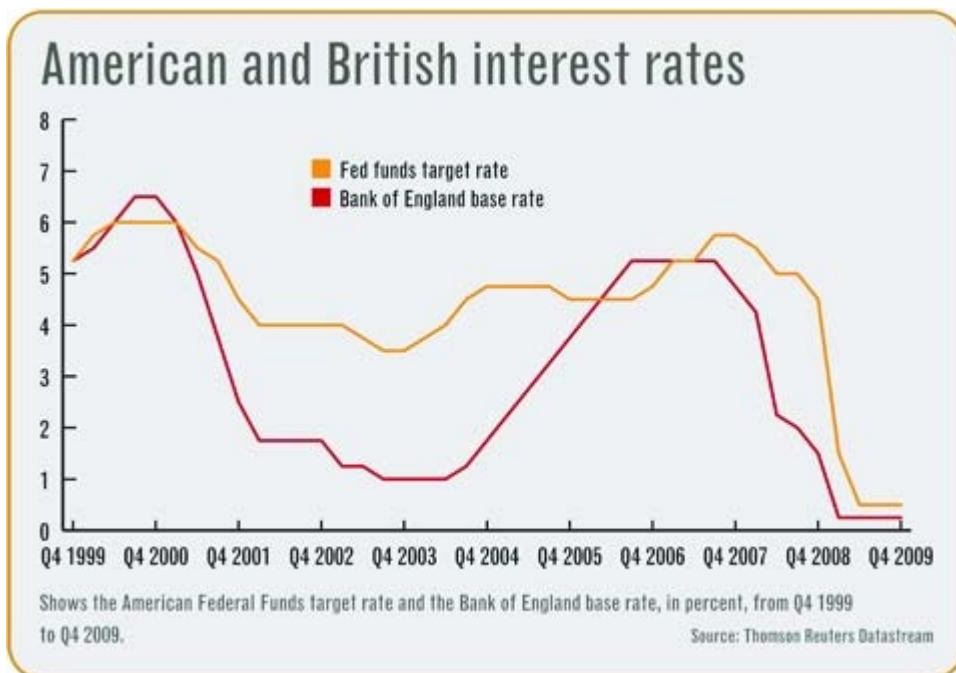
Throughout the American economy, debt has run rampant, with total credit as a percentage of American GDP swelling from 150% to 370% over the past three decades. Uncle Sam has already chalked up obligations for Social Security and Medicare (retirement and healthcare guarantees) of about \$46 trillion; the Federal Deposit Insurance Corporation (FDIC) bank insurance programme is another ticking time bomb; and healthcare legislation under current debate could add to the bill. "For the past quarter century, debt and asset values have been expanding faster than incomes," says Levy. "That is unsustainable."

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It is well known that humans tend toward pattern matching, seeking models for resemblances. Levy bemoans how analysts insist on comparing the post-crisis environment with epochs in the 1960s and 1970s. "It won't be like the 1930s, because the government won't allow that type of collapse," he promises. "But we will have a contained recession, marked by weak, spluttering advances against chronic overhanging problems."

The past decades in Japan present a somewhat better comparison. As Levy warms to the theme, he brands the current climate a "contained depression", during which the authorities must keep the financial sector intact with "duct tape" measures.

"Unfortunately, the unintended effects have been to create a 'new normal' dependency upon these measures," reflects Sury, who also directs The Sury Initiative for Financial Innovation and Risk Management. "When the time comes for many of these programmes to sunset, or when political pressures finally force the introduction of exit strategies, there will be sudden drafts. The government crutch needs to remain until the consumer has the confidence, credit and conviction to increase aggregate demand, but no-one has clarity on when that may occur."



It is hard to discern a catalyst in today's climate, which might kick-start the economy again on a sustained upward path. Brenda Wenning, who runs Wenning Investments in Newton, Massachusetts, examines past recessions. After 2002, after the technology bubble burst, and banks were struggling with corporate loans, the Fed eased interest rates from 6.5% to 1%, making credit available. Liquidity flowed into appreciating home prices, from which their owners extracted equity. Wenning ponders: "This time around we don't have that, so what could be a driving force?"

At Tenex Capital Management, a restructuring firm, Varun Bedi, the chief investment officer, works with clients who are only just starting to feel the pain. "We see the underbelly of small businesses," he reports. To his firm, the crisis began six months ago, when the pipelines of distressed companies began to clog, well after the fall of Lehman Brothers. Typically, restructuring cycles take two to three years.

As consumers deleverage, they are hardly ready to start the new credit expansion necessary for a genuine recovery. Normally, Levy explains, wealth creation would provide the spur, including new assets, fixed investment, buildings, equipment, housing and so forth. With so much overcapacity in residential and commercial real estate however, we do not need to replenish what is wearing out and depreciating. In the second quarter of this year, American net private investment amounted to only a fraction of 1%, compared with a range of 4% to 12%, from 1946 to 2008. "We may see a levelling out in housing construction, but that will be more than offset by declines in the non-residential sector. And a small inventory bounce in spending on equipment will not provide enough of a snapback in the next couple of years - and will help other countries with their own exports more than the US," Levy says.

The financial world has starkly changed over the past year, and is missing one of its most powerful engines: securitisation is largely dormant or dead. The shadow banking system has truly become a shadow of itself, even before expected regulations take effect. As Bedi discusses, "previously, the shadow economy constituted 50% of lending capacity in the US and the UK. Banks are now the only remaining source of credit for companies."

Another sea-change will affect retail spending. "The consumer is out of the game," says Lekas, who brands it "the empty refrigerator syndrome." When the fridge is bare, consumers do replenish supplies, but on a sporadic basis - perhaps when they buy a house for the first time, or inherit money. But those outlays will be inconsistent. Wenning sees a change in spending habits in her own client base. "Some may be unemployed, have lost a job, or watched their wealth deteriorate. They see 'for sale' signs across their neighbourhood as home prices come down, and credit card limits are being cut across the board."

Most of the 5% increase in American household income growth this year is attributable only to the Obama stimulus, and most of it has been stashed away rather than spent. So is saving or dis-saving healthier for the economy? The answer depends on the time-frame. In the long run, more saving promotes financial stability, but short-term adjustments can be painful. The government can only cushion, by running deficits to give the economy time to work off excess capacity and bad debts, until

consumers rebuild their balance sheets to thrive again.

There will be no easy solutions in the new normal we inhabit. In an episode of his American television series, Jerry Seinfeld, the comedian, sums up the dilemma for the dismal science, when he confronts an array of medications on the shelf. One is long lasting; another is fast acting. So, he wonders, when do I want to feel better?

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