

# Strategic Insights

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August 2011

## Divided Interests

The approaching political season is about to bring a new layer of challenges to those trying to stimulate the economy. With the Federal Reserve now taking a more constrained roll in the markets, investors should prepare for volatility.

The hope and goal of policy makers over the past two years has been that the combination of monetary and fiscal stimulus would buy enough time for a self sustainable economy recovery to take hold. It's worked in the past, it should work now. But recent revisions to GDP indicate the recession was deeper and the recovery weaker than previously thought, and a self sustainable recovery has not taken hold.

Policy makers are now facing a stark reality, especially if the economy weakens further and the risks of another recession rise. Monetary policy is running on empty, and there isn't a gas station in sight. The Federal Reserve has promised to keep the Federal funds rate anchored just above 0% for two years. This sleight of hand provides no additional monetary stimulus. After the announcement, not a single bank lowered their Prime rate, nor did credit card companies lower their usury rates on unpaid balances. The Fed isn't pushing on a string, they're pushing on a strand of hair.

## Thirty Years of Fed Policy

During the last 30 years, policy makers have attempted to use a combination of monetary and fiscal policy to mitigate the natural ebb and flow of the business cycle. In the 25 years between 1957 and 1982 (300 months), there were 64 months that the economy was in recession. In the 25 years between 1982 and 2007 (300 months) there were only two shallow recessions, which each lasted 8 months in 1991 and 2001. On the surface, it certainly appeared that the manipulation of monetary and fiscal policy had succeeded in taming the business cycle. In reality, the attempt to defeat the business cycle only succeeded in allowing far larger imbalances to develop. Since these imbalances took 20 to 30 years to develop, they have become structural in nature, and will require five to ten years to work through. As this adjustment period unfolds, our economy and financial markets will remain vulnerable to a heightened level of volatility.

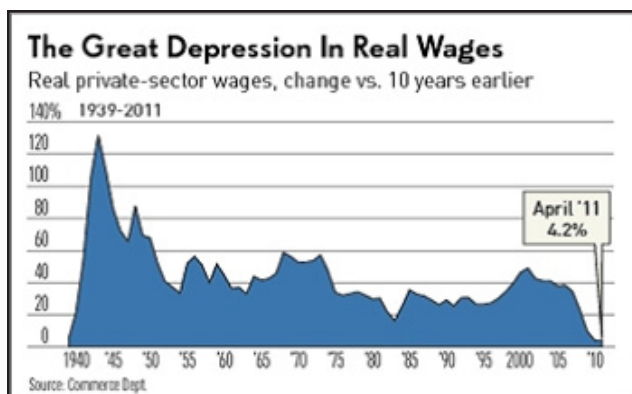
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Since the secular bear market began in 2000, there have been large declines and solid rallies, and we expect that pattern to continue. Traditional asset allocation will not protect investors during market declines, so investors will not be able to simply buy and hold.

## Debt, Debt and More Debt

A quick review of the structural problems we're facing will show why it will likely take five to ten years before a foundation is laid that will support a long term economic expansion. During the window of apparent success, between 1982 and 2007, total debt relative to GDP, soared from \$1.65 for each \$1.00 of GDP in 1982, to \$3.70 of debt for \$1.00 of GDP in 2007. This increase occurred because debt was growing by more than 8% per year, while GDP was rising around 4% per year.

One of the big drivers in the increase in total debt was the significant increase in household debt, which mushroomed from 62% of disposable personal income in 1985 to 135% in 2008. At



the end of 2010, the ratio was 120%. More than half of the \$500 billion decline in household debt since 2008 has occurred as consumers defaulted on their mortgages, credit cards, and auto loans. It would have been far healthier if the ratio was due to healthy gains in disposable income. That's not happening. According to the *Commerce Department*, real private sector wages have increased just 4.2% over the last decade. For most of the past 35 years, the 10 year average increase in real

wages has been more than 25%. This is the first recovery since World War II that there has been no gain in wages and salaries during the first eight quarters after a recession's end. In the 1990's, household debt as a percent of disposable income averaged 89%. The average household would need to cut \$26,172 of debt to lower the household debt to 89%.

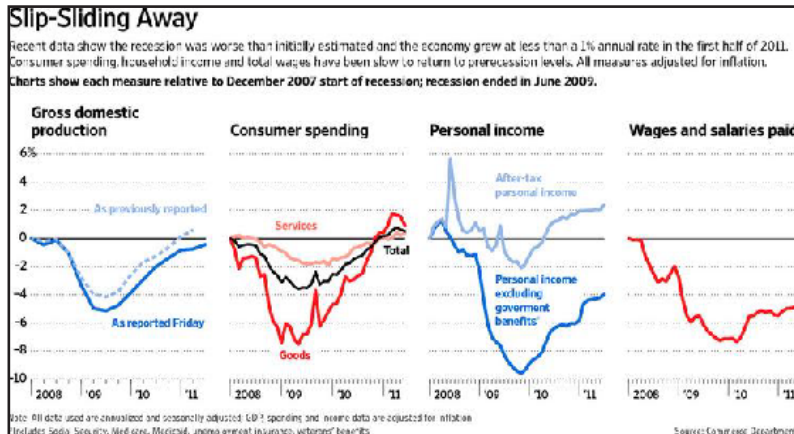
A large portion of the increase in household debt occurred between 2002 and 2007, as homeowners withdrew \$2.69 trillion of equity from their homes, according to the Federal Reserve. The conversion of home equity into consumer spending boosted GDP during those years. As consumers pay down debt, they will have less money to spend, which will result in slower GDP growth. To the extent that household debt is reduced through defaults, banks and other lenders will absorb the losses, which will continue to pressure credit availability in coming years.

## This is Not A Typical Recession

After three years of \$1 trillion+ annual deficits, it is going to be difficult to even maintain the current level of government support, when unemployment benefits expire at the end of this year for 8.9 million unemployed workers, as does the 2% reduction in payroll taxes for all workers. According to *Goldman Sachs*, first quarter GDP in 2012, could be lowered by as much as 1.5%, if the payroll tax cut is allowed to expire. The *Congressional Budget Office* estimates that Federal government spending is down nearly 12% from May 2010. In the first two quarters of 2011, lowered spending by all levels of government reduced GDP by an average of .7%. Reducing Federal spending from 25% of GDP to the long term average of 19% over the next 10 years is the right medicine for the long term health of our economy. But in the short run, it will make the patient weaker.

## Still No Jobs

Since the recovery began in June 2009, the labor market has been exceptionally weak. The labor force participation rate measures the share of the working age population that is employed or looking for work. In July, the participation rate fell to 63.9%, the lowest since January 1984. Of the 13.9 million unemployed workers, 6.2 million have been looking for work more than six months. Another 1.1 million unemployed workers have simply given up looking. In nine of the



eleven recessions since 1948, all the jobs lost during the recession were recovered within 32 months, with most recoveries recouping all the lost jobs in less than 24 months. The two exceptions were the 2001 recession, which took 46 months, and now. It's been 43 months and 5% of the labor force is still unemployed. This is unprecedented.

The depth and lack of a meaningful recovery in the labor market since June 2009 suggests this is another structural problem that has multiple facets. The lack of job growth will weigh on GDP growth, and make it far more difficult at all levels of government to balance their budgets, since the unemployed have less money to spend, which reduces sales taxes. They also pay no income taxes to states or the Federal government. And, unless unemployment benefits are cut off at the end of 2011, spending will remain elevated to keep benefits in place. Future productivity will also be less, as job skills erode the longer a person is out of work.

## Prepare for Volatility

After three rounds of historic stimulus and market intervention since 2009, it is unlikely the Fed will begin QE3 so soon. That news should prove disappointing to investors. Barring another exogenous event we expect an increase in volatility as the world must come to terms with a slowing global economy and as of yet still unresolved sovereign debt crisis in Europe.

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