



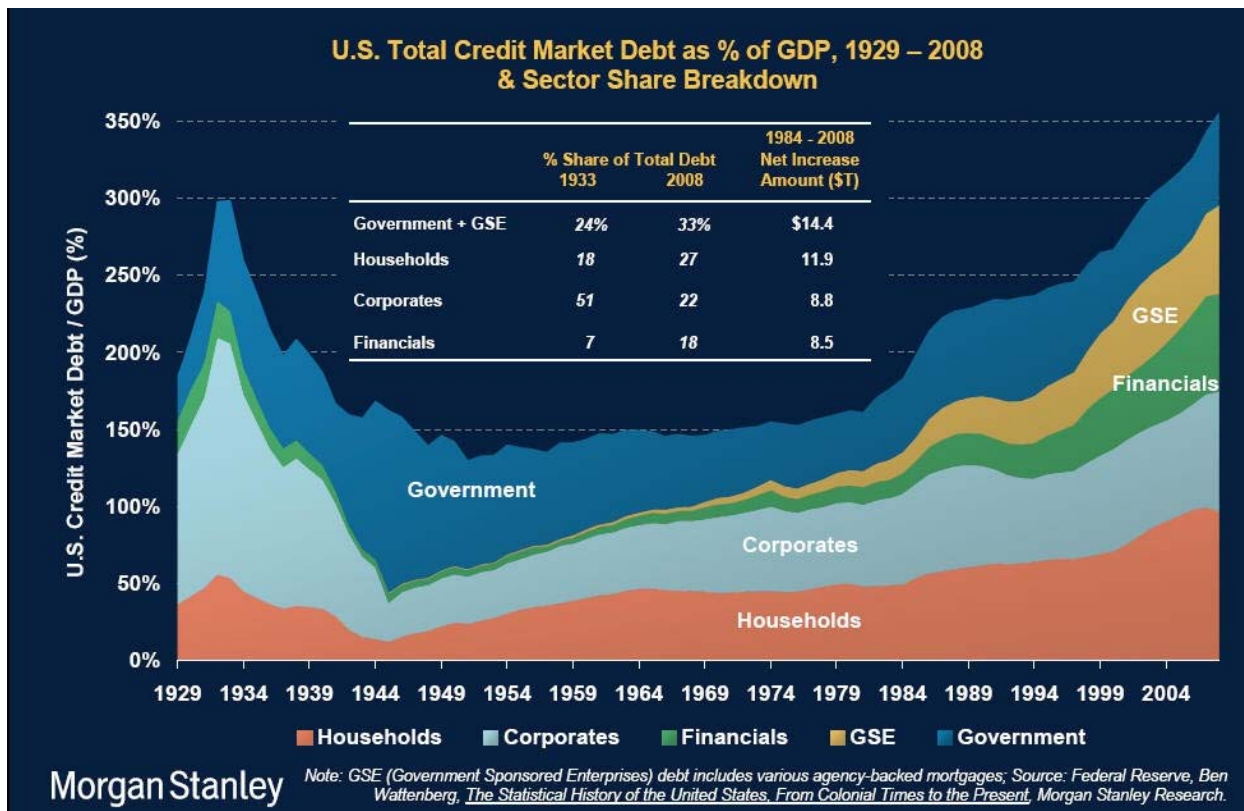
A Mountain, a Molehill, Two Paradoxes and Three R's

With various stock market indices (Dow Jones, S&P 500, Nasdaq, EAFE, Emerging Markets) up between 18% (Dow) and 34% (EM) from their March lows and numerous sightings of the “green shoots” of economic recovery, the bulls have begun to declare victory and trumpet the news that it’s safe to go back in the water.

Unfortunately, I don’t see how it can be that simple. We have some really big issues that need to be addressed in ways that go beyond interest rate cuts, stimulus packages, TARP, TALF, PPIP and whatever comes next. This piece will take a shot at explaining why the road to recovery may be longer than any of us would like.

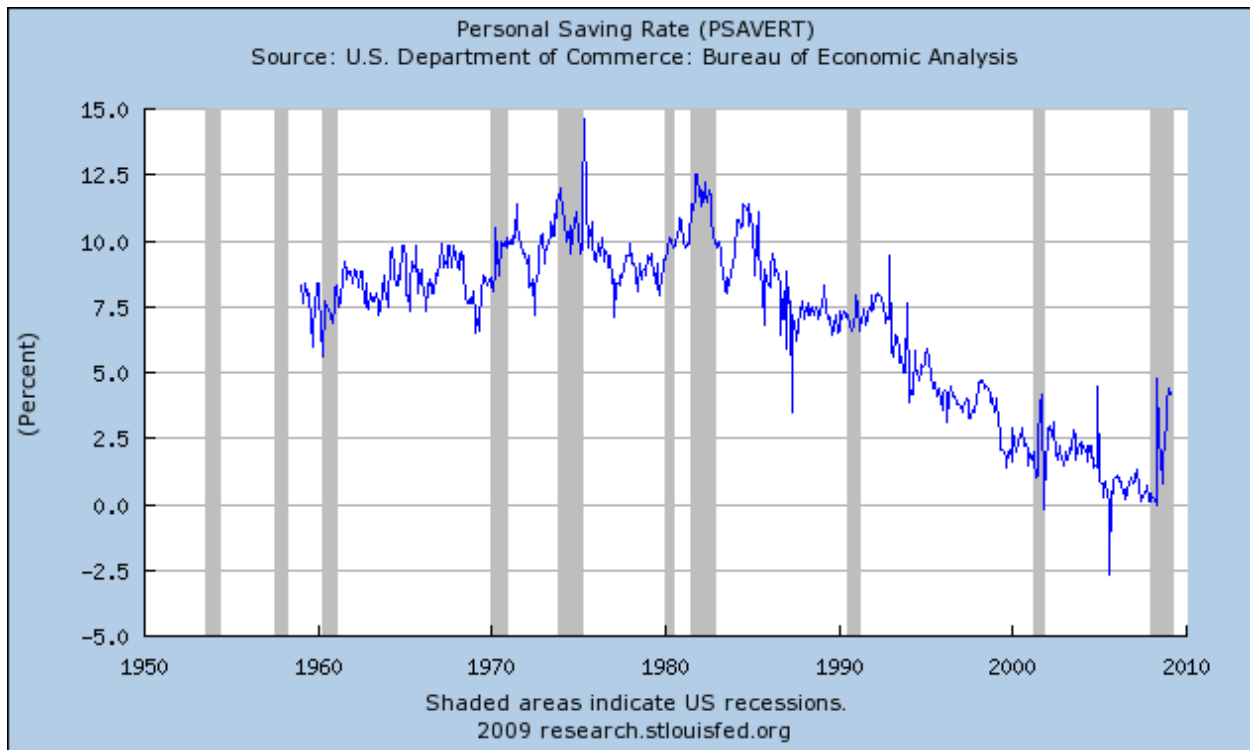
A Mountain

The chart below shows all of the debt we have created in the US as a percentage of our gross domestic product. As individuals, companies and a nation, we owe more than at any point in the last century. Two things make this mountain even more daunting. First, government borrowing is going through the roof as part of the effort to keep GDP from collapsing (i.e. the ratio will be going higher before it has a chance to come down). Second, going into the Depression, foreign countries owed us a bunch of money from post-WWI lending programs – we were a net creditor nation. Today, we owe foreigners a lot more than they owe us – we are a net debtor nation.



A Molehill

The next chart shows the personal savings rate in the US. Coming out of the last bad recession in the early 1980's, the savings rate has been in steady decline. If you look back at the debt chart you will see that borrowing relative to income took off at about the same time. Essentially, we saved less, borrowed more and bought lots of stuff. We are left with a mountain of debt and a molehill of savings.



Two Paradoxes

Given the picture we've painted so far, paying down debt and rebuilding savings both make a lot of sense. But what if everyone does it at the same time. Paul McCulley of Pimco has outlined two paradoxes that currently grip our economy.

The paradox of deleveraging: Back in the good old days, private equity firms, hedge funds and real estate investors borrowed big money to buy companies, stocks and houses because it was clear they could only go up in value and banks were eager to lend. Then values stopped rising. One smart person decided it was time to sell, pay off the loan and book a profit. Then another and another. Pretty soon, selling pressure reduced asset values. As asset values declined, more people tried to grab a profit. Then the profit was gone but the bank wanted its money back because loan-to-value had plummeted. People were forced to sell. Prices went down further. Repeat until banks are selling houses in foreclosure, companies are pushed into bankruptcy and hedge funds are run out of business (and we find out which ones were Ponzi schemes).



But it's not just the people who borrowed too much who are hurt. Anyone who owns the same assets has seen their net worth decimated. Innocent people were trampled as everyone headed for the exits. This is the deflation we have all been experiencing.

The paradox of thrift: Consumer spending has been responsible for more than 70% of US GDP in recent years. Guess what happens when everyone decides they need to save money all at the same time. The economy takes a big hit, businesses suffer from lack of demand for their products and services, unemployment rises, incomes go down and the need to save becomes even more critical. And just to rub salt in the wound, there really aren't many safe places to stash your savings and interest rates are at historically low levels.

Three R's

Consumers, corporations and the government each have to somehow deal with their piece of the mountain of debt. I'm pretty sure there are only three ways to do it:

- Repay it by selling assets or using cash savings;
- Refinance it if you are incredibly creditworthy; or
- 'Rite it off by mailing in the keys or going bankrupt.

Consumers: We are all familiar with the problems ordinary people are having with mortgage debt. Foreclosures are widespread and another wave of rate resets is coming. Credit cards, auto loans, student loans, home equity loans all need to be paid off at the same time that unemployment is rising. Lower energy prices are a help but that can't last forever. Hard to imagine that consumers will pick up the slack in GDP growth any time soon. Easier to imagine a lot of debt 'ritten off, leaving the lenders holding the bag.

Corporations: Many industrial and service sector companies are in pretty good shape – operating efficiently with cash in reserve. The financial sector is a different story. A recent IMF study counts \$1.3 TRILLION of recognized losses by banks and insurers. Unfortunately, this is less than half of an expected total of \$3 TRILLION over the next several years. The auto industry appears headed for organized bankruptcy. John Hussman recently put it this way: “Until we observe large-scale restructuring of mortgage debt and the debt obligations of major financial institutions, we will be applying trillion dollar band-aids (*TARP, TALF, PPIP*) while the underlying cancer metastasizes. The longer we wait to restructure debt, to swap debt for equity, and to expect those who made the loans bear the losses as well, the more we risk allowing this downturn to become uncontrollable and unfathomably costly to the public.”

Government: In its efforts to prop up the consumer and corporations and avoid deep deflation, the government has been using leverage to solve the problem of too much leverage. The good news is that we may be getting everyone off heroin. Unfortunately, we're doing it by giving them morphine. Clearly this cannot go on. The government's unspoken game plan is to re-inflate the economy and pay off the debts with cheaper dollars in the future. Their efforts are doing nothing to reduce the mountain of debt. Without having a vote on the matter, taxpayers



have become the lender of last resort through government programs that fail to address the need for a vast restructuring of debt at all levels.

Conclusion

There can be no question that the consumer is taking a breather as the driving force of the US economy. Can the government take the wheel without driving us into a ditch? By any measure, the stimulative programs unleashed to date dwarf anything undertaken in our history. If we have seen the worst of this, it is only because our officials, elected and otherwise, have spared us one fate only to expose us to another.

“Here’s a challenge. Try to find one asset class that isn’t being distorted by monetary administrations worldwide. Government bond markets? Corporate bond markets? Foreign exchange markets, indirectly or directly? Cash deposits? Trying to invest sensibly now and trying not to incur capital losses, involves playing an elaborate game of chicken with governments.” *(Tim Price, Financial Times, April 7, 2009)*

We may avoid the ditch of deflation only to find ourselves on the road to massive inflation that will destroy the value of our new-found savings. If that dollar in your pocket represents a fractional interest in the United States of America, then printing and borrowing more dollars can only debase the value of the one you have. The impact hasn’t yet been felt because the rest of the world is in similarly bad shape.

As only Woody Allen could say, “More than any time in history mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray that we have the wisdom to choose correctly.”

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