



BOSTON INVESTMENT ADVISERS

## SECOND QUARTER 2010: OUTLOOK AND COMMENTARY

The advent of modern industrial society will result in increasing pressure for social progress [i.e., government services] and increased allowance for social consideration by industry [i.e., taxes].

—Alfred Wagner, German economist, 1835-1917

[Y]esterday's financial crisis could easily morph into tomorrow's government debt crisis.

—Carmen Reinhart and Kenneth Rogoff, authors of *This Time Is Different: Eight Centuries of Financial Folly* (2009)

### I. The Economy

In the fourth quarter of 2009 growth continued apace as GDP advanced at a 5.6% annual rate (and for the full second half of the year a creditable 4%). Yet “pace” is the issue as few observers believe that for the rest of the recovery, which will likely take years, growth can be sustained at anywhere near that level. We should be grateful for a 3% pace for this year and into 2011 and beyond. No wonder Bill Gross and the other all-wise seers at PIMCO claim that 2% growth is the “New Normal.”<sup>1</sup>

Still, we can increasingly be confident that, subject to the major “but” explored below, the risk of a double-dip recession has receded to immateriality. For example, productivity growth is outstanding, and consumer spending fairly robust despite on-going deleveraging. More importantly, housing—though fragile—appears to have reached bottom. The job market—though awful—has likewise apparently stabilized. Yet both remain huge drags on the pace of recovery.

Indeed, let's consider the unemployment picture more fully. The official unemployment rate has not budged from 9.7% for two months, but the economy is now adding jobs though barely at the rate necessary to keep up with population growth and with little chance of restoring the eight million jobs lost in the recession for years and years to come. Worse, the average length of unemployment has reached a record level, and long-term unemployment (defined as longer than six months) is now second only to that seen in the Great Depression. These are not “lay-offs,” my friends—they are jobs lost for a long, long time if not forever; perhaps one-quarter of the eight million have been shipped abroad or rendered obsolete in an information age. Indeed, as warned before in these pages, there is a real risk of “structural unemployment” in this country for the first time in living memory. That could have serious social consequences.

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<sup>1</sup> For context, consider that growth averaged a mere 1.9% a year in the 2000s, the worst since the 1930s, whereas it averaged 3.9% in the previous six decades.

Some wags called the 1990s the Goldilocks economy as it grew neither too hot nor too cold. Now the same could be said of the recovery, yet there is—as noted above—one large threat hovering above: a sovereign debt crisis. In other words as a cyclical matter things look if not rosy then at least somewhat hopeful. Yet as a secular matter we are whistling past the graveyard.

Obviously, since the financial crisis exploded 18 months ago (after smoldering for a year before that), central bankers and other policy makers have effectively struggled to replace excessive private debt, borne of a decades-long credit bubble, with public debt in order to keep private demand from collapsing into depression. This is the classic Keynesian prescription, and while there are lonely voices out there denying it and invoking the draconian remedies of the so-called Austrian school of economists, to the undersigned there is no question that it was the right thing to do.

Yet at the scale that these emoluments have been applied, it is very difficult to see how mere cyclical growth will allow us to pay down those debts, especially as we face the rising fiscal burdens of the Baby Boomers' retirement. Worse, the contagion was virtually universal in the developed world; it was not just another, say, Argentina. So, many countries, including possibly ours, may face the Charybdis of sovereign debt default (think Greece) or the Scylla of inflation. Profs. Reinhart and Rogoff's magisterial masterpiece, quoted in the epigraph above, posits a red line: if a country's government debt exceeds 90% of GDP, it is unlikely to grow out of it, and absent major fiscal austerity (and consequent lower standard of living) it will face the twin evils of default and inflation. It is clear that the U.S. will soon drive by that stop sign without even slowing down.

Yet even the good professors admit that the U.S. may be a special case, as Japan has been for decades. Japan's public debt is about 200% of GDP, but Japanese government bonds have paid no more than a paltry 1-2% for many years.<sup>2</sup> However, as noted in these pages in the past, Japan has the singular advantage, culturally conferred, of a vast pool of domestic savings, individual and corporate. By contrast, Uncle Sam stands at the water's edge, tin cup in hand, begging for money in broken Mandarin. No, where the red line is concerned, the U.S. may be special (given the dollar's role as the world's sole reserve currency and the still near-universal perception of Treasury securities as a safe haven), but it will be no exception.

Editorially, it might be said that "Wagner's Law," set forth in the first epigraph above, has it only half right, at least in contemporary America: people want more things from government, but they do not want to pay for them. Just as in their personal lives (at least until the recent unpleasant reckoning), they expect the government to find the money elsewhere. Thus personal debt stood at 55% of GDP in 1960 but rose to 133% in 2007. Likewise, federal debt equaled 41% of GDP only two years ago but is expected to cross that 90% red line in 2020 (and much earlier if Social Security's massive holdings of Treasury securities are included).<sup>3</sup> Indeed, in that year federal government spending will equal 26% of GDP but tax receipts only 19%. One way or another that is unlikely to happen, but the remedy—increased taxes or decreased spending—will be painful.

## II. The Capital Markets

In a broad sense, asset prices at present reflect the relatively encouraging cyclical picture painted above and certainly have advanced from the lows recorded at the bottom of the financial crisis. At this

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<sup>2</sup>In a general deflationary environment, however, domestic holders of JGBs enjoy a tax-free gain in real terms every year as the bonds rise in real value.

<sup>3</sup>In today's poisonous political atmosphere, it might be helpful to set forth the sources of the estimated \$12 trillion of federal debt to be added from the time Clinton left office (and the federal budget was in surplus) and the end of Obama's present term: 33% can be ascribed to Bush's fiscal initiatives, 20% to those he initiated and Obama continued, 10% to Obama's and a whopping 37% to the recession's impact on tax receipts.

writing, for example, both the price of oil (more of a barometer than an asset) and the yield on the 10-year Treasury note (an anti-asset, admittedly, since its price varies with its yield) are at the highest level since October 2008, and the stock market, as measured by the S&P500 stock index, has gained over 75% since its low in March 2009. On the (inevitable) other hand, the yield on the 10-year Treasury has arguably been on the rise in recent weeks not because of increased credit demand (there is none) or because of concerns of an imminent outbreak of inflation (short term, deflation remains the greater threat) but because of fears of sovereign default. In other words, the bond market vigilantes from the 1980s may be saddling up not so much out of an apprehension of government-induced inflation to ease the repayment burden of its enormous debts but because of a growing conviction that Greece, Iceland and Ireland are just the first wave of governments hobbled by threat of default. Of course, this could be a self-fulfilling prophecy as, like short-sellers in the stock market, they drive up the cost of carry for all governments similarly situated.

Worries over this state of affairs have cast something of a pall over the bond market as major players shorten their portfolios' average maturity (or duration). They are also mindful of the fact that as of the end of March, the Fed ended its massive support program for the mortgage market in particular and the bond market in general. Since November 2008, it has purchased \$1.25 trillion of mortgage-backed securities plus \$200 billion of Fannie and Freddie bonds and perhaps \$300 billion of Treasury securities. All things being equal, the retirement of this giant buyer of last resort (rather like Clifford the dog in the bond market) must mean that yields will rise and prices drop.<sup>4</sup>

Another source of concern is the contrarian (to put it politely) behavior of the individual investor, who stampeded into bond funds from the start of the financial crisis. Now there are signs that he has realized that he just missed one of great rallies in stock market history. Net flows into stock funds have thus turned positive. This is his usual pattern as he typically waits until the second year of a bull market before putting a toe in the water. If he now leaps in, it will be good for stocks but bad for bonds.

Well, what about the stock market? Where does it go from here? The answer now critically depends on corporate earnings (as to one degree or another it always does), which in turn will depend on the strength and durability of the recovery. Given the thesis set forth above, it is difficult to be terribly optimistic on that score. Yes, profit margins have grown importantly, factories are beginning to hum and exports flow, there are absolutely no capacity constraints and the consumer is feeling his oats. Yet is that enough to overcome the economic gravity explored above?

The answer to the question can be said to depend on which of two prominent professors of finance one chooses to believe, Robert Shiller or Jeremy Siegel. Shiller famously called the end of the tech bubble and later warned of a housing bubble. His long-term measure of valuations frequently cited in these pages says stocks (i.e., the S&P500 stock index) are expensive but have been almost all of the last 20 years. By contrast, Siegel looks at forecast (by Wall Street analysts) earnings and finds stocks inexpensive. You pays your money, and you takes your choice . . . .

Jerome W. Anderson  
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We will invest for the long-term while always striving to maximize returns and minimize risk.

We will seek to minimize your investment expenses.

We will not accept any payments or anything of value from third parties that might influence our choice of investments for your portfolio.

We will invest our personal assets in parallel with yours.