BOSTON INVESTMENT ADVISERS

FOURTH QUARTER 2010: OUTLOOK AND COMMENTARY

[The dollar] is our currency but your problem.
–John Connally, Secretary of the Treasury
at the time of The Plaza Accord (1985)

This is not my father's recession.
–Christina Romer, recently resigned chair
of the Presidnent's Council of Economic Advisers

The U.S. is driving down the tracks of a typical post-WWII financial crisis.
–Kenneth Rogoff, co-author of This Time Is Different

Thus we are sensible . . . taking careful thought before we add to the "financial" burden of
posterity by building them houses to live in, that we have no such easy escape from
the sufferings of unemployment.
–John Maynard Keynes

I. The Economy

Portents last spring in the stream of macroeconomic data that the recovery was slowing were confirmed late this summer. From an annual rate of 5.0% in the fourth quarter of last year, when the recovery was in full swing, and then 3.7% in the first of this year, GDP growth slowed to 1.6% in the second. Reasons popularly adduced for this slowdown varied, and perhaps this discussion tends to obscure the fact—officially, according to the gnomes of Cambridge—since June 2009 we have, in fact, been in a recovery. Yet with perhaps four million households credibly estimated to be at risk of foreclosure and 15 million Americans out of work, the decline is most unwelcome. Growth is widely expected to rise somewhat in the just-finished third quarter and the fourth but is unlikely to reach levels that will quickly bring us back to what had been thought to be normal levels of prosperity.

The fundamental reason, as has been emphasized in these pages for some time now, is that financial crises of the sort that precipitated what was the worst recession since WWII are followed almost inevitably by a long period of deleveraging, especially among consumers. For example, in 15 such crises that have occurred globally since 1977, that cycle has taken an average of seven years and has cost an average of one percentage point of GDP growth in each of those years. Here, household debt as a proportion of disposable income peaked at 130% in September 2007 (on the eve, as it happens, of the

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recession) but has so far fallen to only 119% (and foreclosures and credit-card debt defaults have contributed have contributed no small part of the decline). It must get to 100% or lower for deleveraging to finish, but even at the current, relatively healthy 6% personal saving rate, that process will take years.

But what about the $750 billion TARP, the gentle reader (or maybe not so gentle, where this subject is concerned) asks? Or the $800 billion stimulus bill? Or near-zero short-term interest rates at the Fed? Not to mention its purchases of $1.3 trillion of bonds from financial institutions to drive down longer term interest rates (so-called "quantitative easing")? Have they done no good?

Well, despite howls of protest from the right where bail-outs and stimulus are concerned, they have worked but only marginally (and at what cost, it may be asked, in "moral hazard"?). Even King Canute could not command this tide. The most credible study, by Princeton economist and former Vice-Chair of the Fed Alan Blinder and Moody's chief economist Mark Zandi, shows material mitigation of both GDP and private demand decline, but jobs are only an indirect effect of these. (Perhaps more importantly they put a floor under the economy and prevented a depression.) Here the picture is therefore much worse simply because of a massive loss of confidence. As the husband and wife team of Carmen and Vincent Reinhardt, experts on the subject, have recently written, in severe economic dislocations like this one, "The unemployment rate stays high because it has been high." It is caught, in effect, in a negative feedback loop.

What tools are left in policy-makers' box at this point? Certainly nothing having to do with fiscal policy as partisan and ideological rancor in Washington (compounded by the de facto codification of the supermajority requirement in the Senate's filibuster rule) have neutered the Congress. As to monetary policy, the drumbeat from the Fed says that another round of quantitative easing is imminent (universally dubbed QEII). Still, at this juncture it is hard to see that such an effort could be more than symbolic. With banks' collectively holding some $1.3 trillion of reserves at the Fed, where they earn a pitiful 0.25%, what will induce them to lend any greater amounts that appear in their accounts by virtue of QEII? Will the symbolism of the Fed's effort be enough to summon animal spirits from the vasty deep (to mix metaphors). One is inclined to be skeptical.

Three months ago at this writing, the big concern—for both pundits and investors—was a foreign country and its currency and their threat to global recovery. The same is true this time, but now the country is China, not Greece, and the currency is the yuan[1], not the euro. In a word, the prospect of a currency war looms, one that could turn into a trade war, which could lead to disaster. Even doctrinaire free-traders now say that with China and its "managed" currency, enough is enough. Those on the other side of ideological divide, of course, have long called for policy intervention to save an increasingly "hollowed out" manufacturing sector in this country. Now they have jointly persuaded the U.S. House of Representatives to pass legislation that threatens to, well, blow the Chinese house down if it refuses to revalue its currency[2] in order to close the huge trade gap. Chinese insistence that this might lead to the shuttering of hundreds or thousands of factories, force millions of uplifted peasants back to the impoverished countryside and thus raise the horror (to Chinese elites for millennia) of social unrest is no longer credible. Nor is its defense based on the West's enforced revaluation of the yen in 1985 (known as the Plaza Accord), after which the trade gap between the U.S. and Japan did not shrink

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[1] Or the renminbi—the Chinese no longer distinguish between the two.

[2] History buffs are delighted by the delicious irony that the bill would formally amend the Smoot-Hawley Act of 1930, considered as one of the chief causes of the Great Depression yet still on the books!

for several years. The Japanese thereafter, the Chinese argue, experienced a huge bubble in property and shares, which duly burst and left the Japanese economy in a torpor from which it has never fully recovered. All of that, most observers believe, was the result of Japanese mismanagement of fiscal and monetary policies.

In truth, revaluation of the yuan is not likely a sufficient condition and perhaps not a necessary one to narrowing the trade gap. More important in a command-and-control economy like China's—communism with a somewhat human face—is its abandonment of the export-led model of growth, which following Japan and Korea has worked so well, and the redirection of the economy towards domestic consumption. It is astonishing that consumption today represents only 36% of the Chinese economy, about half of the proportion in the U.S. and almost 10 points less than it was in China some years ago. To do so, China must loosen its controls over capital flows and cease or greatly moderate its intervention in currency markets at the same time. If they refuse, protectionism is not the answer. Instead, the West should begin to restrict Chinese access to government securities markets. That would greatly diminish its ability to prevent an outbreak of severe inflation at home. If it takes legislation, it should be called the Nixon Act![3]

II. The Capital Markets

In the face of these lugubrious themes and currents, the stock and bond markets have displayed remarkable insouciance over the last three months. For the bond market, it is a secular story: continuing deleveraging means more disinflation (though so far no actual deflation—thank heaven) and therefore falling yields. That means, of course, bond prices must rise. Many observers see this as a bond bubble, the third asset bubble in a decade, they believe, after tech and internet stocks 10 or more years ago and housing roughly five years later. Certainly there is lemming-like behavior at work as investors have fled in anxiety if not panic into the bond market. Yet it is that very motivation that distinguishes this episode from the other two, which were fuelled by giddy greed. In this case, if—as some Cassandras prophecy—interest rates rise because of a booming economy or the pressure of government deficits (somewhat inconsistent scenarios), then bond prices will fall. On the other hand, if we do have deflation, then anything with a fixed principal (especially if of high credit quality) will be most secure. Caught between this Scylla and Charybdis, the investor should remember that today's very low yields offer scant protection against interest rate rises, should they occur. The math simply is not in the bondholder's favor in that case.

The stock market continued to see-saw cyclically after the historic rebound that took it up some 80% from its depth of early 2009 until April of this year. After that, concerns about the slowing economy against the backdrop of a crisis in Europe produced a swoon that lasted until late this summer. Then a nice rally in September (ordinarily a poor month for stocks) took the naysayers by surprise, leaving the market in slightly positive territory for the year. The reality is that despite all the reasons for pessimism explored above, corporate performance—not excluding the beleaguered financial sector—has been excellent. To borrow a phrase from the playground, corporate America is lean and mean.

Its balance sheet, for example, is unusually strong, sporting a collective $1.6 trillion in cash. As a percentage of assets, that is only slightly less (0.4%, to be exact) than the record of 6.4% set in 1964, near the high-water mark of the American imperium. And with interest rates at such low levels, the

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[3] Richard Nixon tried in various ways to protect the U.S. dollar but most notoriously when in 1971 he unilaterally revoked its convertibility into gold and effectively ended the post-WWII international financial system called Bretton-Woods.

new-issue bond market is humming. In the words of the old rock song, it is money for nothing. AAA-rated IBM thus issued $1.5 billion of three-year notes in August with a coupon of an astounding 1%. What are companies doing with the fruit of this cornucopia? Well, not much, at least as far as hiring and capital expenditure are concerned. The only significant deployment of the cash accumulated appears to be in share repurchase programs and M&A., both good for stock prices.

Of course, it is operations that are producing such a geyser of cash as reported profits (not the same thing, of course, but a good proxy) for the S&P500 group of companies rose 38% year over year in the second quarter, an all-time high. For all reporting companies that figure was 26.5%, and it reflected the highest annual dollar rate of aggregate profits growth of all time: $1.2 trillion.

Behind the excellent profits growth lay high profit margins. Again, for the S&P500, the average was 8.4%, higher than even in the tech bull years, when margins and profits were inflated by collective self-delusion. On the other hand, the worm in the shiny apple is that productivity growth has finally slowed from its blistering pace of 6.2% in 2009 and turned negative in the second quarter (-1.8%). With private sector hiring barely positive and official unemployment at 9.6%, this is not surprising. Nor is that fact that unit labor costs are rising. In simplistic essence, management has squeezed everything it can out of its existing workforce and refuses to hire in the absence of greater growth in demand. It is a paradox.

If such "sentiment" among business leaders remains muted at best, what about that among investors? Well, surveyed sentiment among individual investors, investment advisers and Wall Street strategists has generally turned bullish after the bearish gloom of last summer. Behavior, however, has not followed suit as individual investors continue to flee stocks in favor of cash and bonds, which yield little or nothing but are perceived as safe.

In fact, one measure of relative value of stocks is the so-called equity risk premium, which compares the yield on the 10-year Treasury with the earnings yield (the inverse of the price-earnings multiple) of the S&P500. That figure is now a little under four percentage points, which is high and makes stocks look attractive. Simply put, corporate earnings performance has been quite good just as government yields have continued to fall, creating a very large gap. And it really is more a function of the latter—falling bond yields—than the former—the earnings yield on the S&P. The latter is good, all right, the best in five years, but not as significant as those ultra-low yields.

Jerome W. Anderson
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