Lebed Asset Management LLC

Investment Commentary—October 2009

Three months ago we suggested the recession would soon end but cast doubt on the durability of the recovery. The picture we described remains very much intact. We can now say with confidence that GDP has turned positive. Inventory rebuilding, together with growing fiscal stimulus, seems likely to produce several quarters of respectable growth—something like 3% on average. However, the recovery will be fragile and a rising tide of foreclosures, growing troubles in commercial real estate, ongoing cuts in state and local budgets, and the inevitable stimulus withdrawal are likely to weaken the economy by late next year.

The goal of fiscal stimulus is to kick-start private demand. The idea is that after a quarter or two of intervention, private demand begins to grow. Ideally it's continuing to *accelerate* a few quarters later. If so, stimulus spending can be wound down without derailing the recovery. Government spending goes down, but accelerating private demand more than makes up for the decline.

The problem is that it takes pretty rapid growth in private demand to pull this off, and it's not clear where it comes from. Residential construction is finally creeping upward, but increasing foreclosures will add housing inventory and put downward pressure on builders. Commercial construction will remain weak for the foreseeable future due to high unemployment (fewer jobs means less demand for office space) and a troubled commercial mortgage sector. Business investment may grow significantly, but a sustained investment boom is usually based on expectations of rapid growth elsewhere in the economy. Exports are likely to contribute, especially if the dollar weakens further, but not enough to pick up the whole load. That leaves the consumer, who is unfortunately drowning in debt.

It's worth diving into the details on consumer debt. The news is unpleasant, but not nearly as dire as some have suggested. In May of this year, PIMCO, a highly influential bond manager, coined the phrase "the new normal," arguing that the overhang of consumer debt will result in low growth in the U.S. economy as far as the eye can see. PIMCO's global strategic advisor Richard Clarida recently wrote that "the world economy needs to be prepared for the U.S. to be the caboose of the global growth train for at least the next five years." While we agree that consumer balance sheets will hamper near term growth—as we put it three months ago, the recovery will be weak, protracted and bumpy—talk of at least five years of low growth seems much too pessimistic.

The standard metric for consumer debt is total household debt as a percentage of disposable income: roughly speaking, how much the average family owes in relation to their earnings. This ratio ranged between 60% and 65% in the '60s, '70s and early '80s. In the mid '80s, disinflation ushered in lower interest rates and led to a debt explosion. The consumer debt ratio quickly soared to 80%, then climbed over 90% in the '90s and reached an astonishing 131% in late 2007 before declining to 125% at the end of this year's second quarter. It's difficult to say with confidence what a sustainable ratio would be, but several economists we follow point to the 90% level of the late '90s—a hefty 35 percentage points below where it stands today.

If it has taken nearly two years to shave 6 points off the consumer debt ratio, surely it will take another decade (the new normal) to cut an additional 35 points, right? Not necessarily. Assuming some modest growth in disposable income[1] over the next several years or so, debt will have to come down by about $4 trillion. That's a big number, but a very hefty chunk of it will come in the form of charge-offs, mostly on soured mortgages. The ultimately tally of mortgage losses resulting from the U.S. housing crisis will be far in excess of a trillion dollars, the vast majority of which is yet to come[2]. When you add in credit cards and other consumer debt, debt reduction from charge-offs over the next two years or so could easily hit $2 trillion[3]. That would leave another $2 trillion of debt repayment. To pay down that much debt any time soon, consumers will have to save more, but that process has begun. As of the second quarter, the savings rate had reached 4½%. Some economists expect it to reach 8%. (By way of comparison, the savings rate typically ranged between 7% and 11% in the '60s, '70s and '80s, fell into the 4% to 6% range for most of the '90s, and sank to an unsustainable 1% to 4% during the housing bubble.) With disposable income around $11 trillion, an 8% savings rate generates nearly $900 billion in savings a year, enough to chip away at the $2 trillion at a pretty rapid pace[4].

More important than trying to guess how quickly debt will return to sustainable levels is this: increasing savings rates only constrain growth in consumer spending *while they are increasing*[5]. Once the savings rate peaks, consumer spending can return to normal growth

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[1] The assumption of modest growth in disposable income is significant. In particular, some have suggested that high unemployment will lead to wage deflation and cause disposable income to go down. There's no evidence to suggest this is happening, but if it did, it could seriously impair debt reduction.

[2] While seriously delinquent mortgages have been building for some time now, foreclosures have proceeded quite slowly due largely to the Obama administration's not very successful efforts to encourage loan modifications in lieu of foreclosures. Charge-offs don't occur until the end of the foreclosure proecess; hence, the comment that the vast majority of mortgage losses is yet to come.

[3] Rough estimates of future charge-offs can be derived courtesy of the Treasury department's "stress test" last spring of large banks. Treasury's "more adverse scenario" is most applicable--unemployment is actually worse than assumed in the adverse scenario; housing prices somewhat better. Applying the loss rates assumed in that scenario to outstanding debt levels supports our assertion that charge-offs in the next couple of years or so could easily hit $2 trillion.

[4] The bulk of savings would normally end up in retirement vehicles. One of the unfortunate consequences of consumer deleveraging may be that 401ks and IRAs are put on a starvation diet.

[5] To wit, suppose disposable income is $1,000 and consumer expenditures are $950, leaving $50 of savings, a savings rate of 5%. If disposable income goes up 2% the next year and the savings rate remains constant, disposable income

rates. And if the peak savings rate is high enough (8% would certainly suffice), consumers will in the not too distant future be able to increase spending a little more quickly than the growth in disposable income and whittle down debt at the same time.

Putting all of this together, here is how the next several years might unfold: following a few quarters of respectable growth (perhaps 3%, give or take), consumer retrenchment will cause the economy to ebb--probably late next year. A double-dip recession is possible, but if the Fed keeps rates extremely low throughout 2010 and Congress chips in with some combination of extended unemployment benefits and state and local aid—all of which we expect will happen--GDP should stay positive. The weakness could last several quarters or more but before too long—perhaps two years from now—the savings rate should begin to peak. As that happens, consumer spending is likely to pick up and gradually accelerate, and a durable recovery can finally take hold. By then, or shortly thereafter, some of the drags on growth that concern us in the near term—growing foreclosure inventory, a troubled commercial real estate sector, state and local budget cuts--could be in the process of turning around, adding strength to the recovery and eventual expansion.

Waiting a couple of years or so for the elements of a strong recovery to come together will be quite painful if you're out of a job and the unemployment rate remains stuck in the vicinity of 10%. But if vigorous growth can be expected to arrive in, let's say, 2011 or 2012, the outlook is much brighter than the one PIMCO conjures of a new normal in which U.S. growth rates lag for at least five years.

Of course, if the economy begins to stagger some time next year, or evidence accumulates that it will, then stocks, now about sixty percent above March lows, could be in for a rough patch. That's why we've allowed cash levels to accumulate a bit in client portfolios and continue to stick by and large to high quality stocks. We wouldn't be terribly surprised if stocks gave back a big chunk of recent gains some time in the next few quarters. Most of the pain would be in stocks with volatile earnings and less than stellar balance sheets—the kind we've avoided pretty strenuously over the past year or two. We would look to put some of the cash we've accumulated to work in any significant pullback and maybe even selectively temper our high quality bias in favor of stocks more dependent on and able to benefit from the durable and robust recovery that we expect to be deferred but not denied.

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will be $1,020, savings will be $51 and expenditures are $969, a 2% increase. I.e., a constant savings rate allows consumer spending to increase at the same rate as income. We first became aware of this point listening to an interview of Ian Shepherdson, chief economist of High Frequency Economics. In the same interview Shepherdson cited the figure of $4 trillion in debt reduction needed to return to a sustainable level of consumer debt. We subsequently confirmed the plausibility of this estimate.