

Investment Commentary—July 2011

It has now been four years since tremors first rattled in a then obscure corner of the credit markets. The collapse of a Bear Stearns subprime mortgage bond fund turned out to be the canary in the coal mine presaging the worst financial crisis since the Great Depression. The recovery has been painfully slow. Signs of a pickup emerged toward the end of last year only to be dashed a few months later. As we ponder where things go from here, it might be well to step back and ask how the economy has proceeded over the last several years as compared with expectations in the immediate aftermath of the crisis.

We wrote in July of 2009, “the recovery is likely to be weak and protracted and could be pretty bumpy to boot.” Indeed. To be sure, there have been some surprises. Foreclosures have proceeded much more slowly than we imagined. And while we saw the risk of a sovereign debt crisis, we did not realize that it would begin in the periphery of Europe and threaten the viability of the currency union itself. However the general course of events has met expectations. We highlighted a host of issues we expected to weigh on the economy for many years: deleveraging of consumer balance sheets, a mounting wave of foreclosures, state and local fiscal crises, and excess housing supply. While there’s been considerable progress on all fronts, these problems continue to bedevil the economy.

The point of reviewing prior expectations is not to pat ourselves on the back but to recall that it was always bound to be a long slog. As economists Ken Rogoff and Carmen Reinhart documented in painstaking detail in their book *This Time is Different: Eight Centuries of Financial Folly*, major financial crises are always followed by painfully slow recoveries. To be sure, things looked decidedly more upbeat six months ago. The second round of quantitative easing (QE2) from the Fed triggered a nearly thirty percent runup in the stock market¹ that buoyed the economy. Job numbers perked up and GDP forecasts were raised. The tone in these pages became decidedly more upbeat. We should have paid more heed to Rogoff and Reinhart’s research not to mention our own earlier commentary.

Two of the culprits responsible for the current “soft patch” are what economists call “exogenous shocks:” the recent oil price spike prompted by unrest in the Middle East, and global supply chain problems resulting from the Japanese tsunami. The oil

¹ The thirty percent figure is measured from Chairman Bernanke’s August 2010 speech that signaled QE2, not from the actual implementation which came significantly later.

price and supply chain shocks were exacerbated when state and local governments, receiving fewer dollars from Washington, sharply curtailed spending. Would the economy have maintained its momentum without the oil price and supply chain shocks? Certainly the GDP numbers would be looking better—1.8% in Q1 and about the same (if not a little worse) for Q2. And the recent dismal job numbers—only 43,000 jobs created between May and June—would have been higher. But with fiscal stimulus having more or less run its course, the Fed committed to staying on the sidelines unless things get significantly worse², and consumer balance sheets and the housing market still enfeebled, expectations of GDP growth pushing 4% were probably unrealistic. Gas prices are now down 30 to 40 cents from the May peak and supply chain issues in Japan are expected to be resolved within a month or two. So the second half of 2011 should be considerably better than the first. But the likelihood of any kind of vigorous recovery this year—one that would quickly put a serious dent in the unemployment rate for example—is slim.

Though it won't begin in the next few quarters, the groundwork for a more vigorous recovery is gradually being laid. Consider state budgets for example. Fiscal support from the federal government is winding down, which led to the sharp cuts mentioned above. But with tax revenues on the upswing, the budget picture will be considerably more benign a year from now and state governments could become a positive factor in GDP growth³. Housing vacancies (single-family and multi-family combined) continue to decline at a rapid pace. Multi-family construction is already starting to pick up, and there's a good chance single-family construction will begin to pick up next year. Foreclosures on the other hand have been maddeningly slow. There have been 3½ million homes repossessed since the financial crisis began, but elevated delinquency statistics ensure another several million to come. That's a lot more keys Fannie Mae, Freddie Mac et al need to collect. In the meantime these several million renters-to-be constitute a "shadow inventory" that hangs over the housing market. Completing the bulk of these foreclosures will bolster housing prices and accelerate the consumer deleveraging process. It will also provide bankers with a final tally of mortgage-related losses, which should spur bank regulators to loosen their tight grip on credit. Even though it's not happening as fast as we would like, mortgagees are repossessing 70,000 houses a month. Slow, steady, not to mention very painful, progress.

Of course any progress will be for naught if Congress doesn't raise the limit on the debt ceiling in the next few weeks. Republicans have insisted for months that any vote to increase the debt ceiling must be accompanied by a significant package of deficit reduction. Democrats demand that any deficit reduction include significant increases in taxes from wealthier Americans, something that's anathema to the GOP. As of this writing the two sides are in a standoff.

² Very recent remarks by Chairman Bernanke in testimony to Congress sparked speculation that QE3 might be on the way. However, Bernanke was clear that additional Fed intervention would be contingent on a return of deflationary forces. We're a long way from that.

³ The fiscal situation of local governments will take longer to recover. Municipalities rely on property taxes and with housing prices still going down (at least through March), property tax collections have yet to bottom.

Capital markets seem confident that a deal will be struck, and we certainly hope that happens. However, while a last-minute compromise is the most likely outcome, a bit of healthy fear is probably in order. Many dozens of GOP House members have vowed not to vote for an increase in the debt ceiling under any circumstances, while another large group has expressed extreme reluctance. Even if congressional leaders and the president agree on a package, getting it through the House will require all the skill Republican leadership can muster. In recent days Senate Minority Leader McConnell proposed a convoluted scheme that would authorize Obama to lift the debt ceiling unilaterally; the plan would permit Republicans to disapprove of such an increase, but this disapproval would be subject to the president's veto pen. It's just the sort of ugly compromise that Congress might adopt. It might have to.

While markets have been uniformly sanguine on U.S. debt ceiling discussions, they experienced significant jitters this spring over the debt crisis in Europe. The immediate cause of anxiety was tension preceding release of the fifth tranche of the €110 billion Greek bailout. Since the bailout was put together in May of last year, Greece's fiscal situation has continued to deteriorate. While the originally allotted €110 billion would take Greece well into next year, it's now clear that Greece won't be anywhere close to returning to the capital markets by that time and a second bailout package will be required. Germany began making noises that it was time for bondholders (primarily European banks) to take a "haircut," bond talk for agreeing to get less money back⁴. But if bondholders agree to a haircut, Greece would be considered in default, which, among other things, would force bondholders to take large writedowns potentially triggering a European banking crisis. It would also greatly exacerbate the debt problems facing Ireland and Portugal; European finance officials are understandably reluctant to fight a three-front war. Eventually Germany backed down, the Greek parliament defied violent protestors to pass the latest requisite austerity legislation, and the fifth tranche was released. The can has been kicked all the way to September when European officials promise they will put another bailout together. Fortunately comments from European authorities in the last couple of weeks have been increasingly realistic. Austerity programs, asset sales and rolling over debt won't solve Greece's debt problem. Authorities seem at last to understand that a major restructuring is inevitable, and the consequences, whatever they are, must be faced. September could be interesting.

The forces holding the U.S. economy back will eventually begin to dissipate, but the recovery will proceed in slow motion for at least a few more quarters. In the meantime governments on both sides of the Atlantic are struggling awkwardly to control debt. Mindful of the downside risks, we've been gradually increasing the defensive tenor of client portfolios over the last several months and continue to do so.

*July 15, 2011
Boston, MA*

⁴ Or loosen the terms of repayment in some other fashion.