Investment Perspective

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THE TIDE IS COMING IN AGAIN

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The economic recovery continues to gain traction. Like the ocean's tide, the extraordinary stimulus from central banks globally simply could not be denied. Nevertheless, the stock-market rebound that foretells the recovery can also obscure its uneven and tenuous nature. Corporate profits are rising, but the next few quarters will reflect the tension between an improving economy and higher interest rates.

Diet leads to corporate health

Corporate America, in general, is in fairly good shape for having confronted the steepest contraction since the 1930s. Already lean coming into this business cycle, firms still cut costs sharply as the downturn commenced. In hindsight, such cuts were probably too draconian. But at the time, a reprise of the Great Depression could not be ruled out. Corporate cash flows are now running at record levels and balance sheets of larger businesses are solid, at least outside of the financial services sector.

A key mitigating factor during this mother of all recessions has been overseas demand for our companies' wares. The developing economies, led by China, have proven remarkably resilient. As a group, they did not get caught up in the housing-credit-spending bubble that poisoned much of the developed world. And the Chinese, the marginal consumers of many goods and products, enacted a massive fiscal stimulus to counter their drop in exports. What Chinese policymakers fear most is social unrest; hence, the need for vigorous and steady economic growth to absorb tens of millions of rural workers into the urban workforce.

Chinese tightrope

But herein lies a key risk to the global recovery story that the market has embraced. Namely, can Chinese policymakers walk the fine line between supporting growth and inflating an asset bubble (or bubbles)? Last year, "encouraged" by Beijing, banks increased their lending by a sum equivalent to almost 30% of Gross Domestic Product (GDP). Most of this money went to finance capital spending and infrastructure. Policymakers are today reining in credit growth. At this point, it appears that this risk of overheating has subsided and that China will enjoy a soft landing; that is, a return to more normalized growth.

The other key risk to global recovery is of course the American consumer. In the past, one of the biggest sucker's bets was against the resilience of U.S. households.

And, in fact, consumers are spending again today. Trends in housing prices and jobs will go a long way toward determining consumers' return to form. Home prices have stabilized in many markets, although odds are they will stall at their much lower levels. Interestingly, last month at the one-year anniversary of the stock market's bottom, businesses actually added more jobs than they cut. This follows the elimination of 8.5 million jobs, the largest drop in both absolute and percentage terms in the postwar period.

Rebuilding the dream

However, structural factors such as the need to deleverage point to a muted rather than robust recovery in consumption. The spending binge of the last decade was driven by rising property prices and easy credit, not by income growth. Consumers should thus be in a mode of rebuilding their personal wealth.

Despite signs of recovery, there is an undercurrent of angst throughout our nation. It is palpable and manifests itself in several ways. Part of this has a political dimension, the increasing balkanization and partisanship that seem endemic to national discourse. This phenomenon is certainly not new but reached a new level of stridency beginning with Bush II. However, we would argue that the pessimism stems more from economic issues — specifically, from individuals' doubts about their own financial well being, America's place in the world order, and our government's role in addressing some acute, long-term challenges. These are all issues previous generations have had to wrestle with. Indeed, the prevailing mood is in some ways reminiscent of that of the late 1970s/early 1980s.

Cloudy circumstances

With one in six workers unemployed or under-employed and one in four mortgage holders under water, it is hardly surprising that folks are less than sanguine. Similarly, small business owners are not much more encouraged today than they were at the depths of the recession. They lack access to credit that their larger brethren can tap for breathing room. Their outlook is critical: Small businesses have historically accounted for two-thirds of new jobs.

In the capital markets, pessimism can be inferred from the relatively low level of trading volume on the stock exchanges, despite the strong rally. And the new money has been flowing much more robustly into bond mutual funds than into stock funds. Two severe bear markets in less than ten years have a way of dampening confidence. On top of that, the most valuable asset for most consumers — their home — is worth a lot less than it was three years ago. So individuals are understandably anxious. But that view will improve as more signs of a rebounding economy emerge, particularly more jobs.

China, Inc.

Meanwhile, America's global hegemony is in question. Again our great economic nemesis seems to be coming from the East. Whereas in 1980 it was Japan, in 2010 it is China. Remember Japan? From a revolutionary manufacturing system to a workforce single-mindedly focused on quality control, Japan, Inc. was going to turn the U.S. into a nation of hamburger flippers. Tokyo's neo-mercantilist economic policies favoring certain industries were lauded as superior to our own. With apologies to McDonalds Corporation — which by the way now obtains two-thirds of its sales from *outside* the U.S. — we weathered the 1980-82 recession, got back to the business of innovating and efficiently allocating capital, and government got out of the way.

But once again, it is treated as inevitable that the locus of economic power will shift to the East. Just as Japan did not bury us, nor will China. Take the widely presumed demise of U.S. manufacturing. Yes, the number of factory jobs has dropped dramatically over the past thirty years. And granted, everywhere one seems to turn, "Made in China" appears on the product label. However, U.S. manufacturing output has *doubled* in real terms over the last two decades despite the loss of jobs. The world's leading manufacturer in terms of the total value of goods produced is — shockingly — the United States. Just before the recession, American factories accounted for 20% of global manufacturing output, while China, although narrowing the gap, stood at 12%. At the risk of oversimplifying, it is a still a case of value-added over volume.

This is not to discount the enduring impact that the Middle Kingdom is likely to retain on the global landscape. The narrative has been China's shift from a rural to urban society. Urbanization has coincided with industrialization, which in turn has raised productivity and personal wealth. But economic growth is not a zero-sum game. They need a strong U.S. and we need a vibrant China. China is both a formidable competitor and important consumer. Indeed, the term *Chimerica* was coined to capture the codependence of the two nations.

Deficits block growth arteries

Lastly, there is a real question as to whether our elected officials are truly up to the task of addressing the nation's challenges. The chronically dismal approval ratings for Congress cannot be squared with the 90+% incumbent reelection rate. Voters apparently must view their own representatives favorably and dislike the others.

In the language of federal budget deficits, trillion is the "new billion." But more important is the size of deficits relative to the economy, and the outlook is not good. Between 1970 and 2008, the budget gap averaged about 2.5% of GDP. In 2009, it stood at 10%. Under the President's budget, outstanding public debt will rise from 50% of GDP in 2009 to 90% by 2020 as the deficits accumulate. Various studies have shown that when public debt approaches 100% of GDP, eco-

nomic growth really hits a headwind. By 2020, the annual interest paid to service the debt will itself approach $1 trillion, taking 20% of all government revenues.

Moreover, these figures precede most of the surge in Medicare spending that will occur after 2020. The recent health-care legislation was much ballyhooed as reform, but it actually is just an expansion of insurance coverage. While that is laudable, the critical challenge is to reduce the growth rate of health-care costs, to "bend the curve." This issue has been conveniently (and irresponsibly) disregarded. The health reform package is supposed to reduce the deficit, but that will likely prove a pipe dream. The plan relies on front-end loaded revenues and back-end loaded expenses; it also relies on future Congresses to legislate more money to pay for some of the programs.

Time is our ally — for now

The stakes are high, but Congress does not seem to recognize the urgency of getting America's fiscal house in order. Our country's circumstances and options are very different from those of Greece. Yet that nation's current crisis is a shot over the bow to us and to all other developed economies with social welfare states. Hard choices have to be made that will affect many constituencies. We cannot simply raise taxes as those on the Left advocate nor can we merely cut spending as others on the Right suggest. The math won't work out.

Large deficits and growing debt will require the U.S. Treasury to issue more and more paper. This will eventually crowd out private borrowing and cause interest rates to rise. At some point, the bond market will force policymakers' hands. The good news is that there's still time to address our fiscal challenges if our representatives can find the political will.

In the near term, investors will focus largely on the emerging economic recovery. In other words, the cyclical story should supercede concern for the potential structural impediments that loom out over the next decade. The backdrop should remain generally friendly to stocks until monetary conditions worsen and investors start to become overly optimistic again.

— Christopher J. Singleton, CFA, Managing Director
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