The Road to Perdition?

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In terms of our current economic quagmire, there is plenty of blame to go around. We can fault the complicit blindness of the ratings agencies, the greed of the banks, the incompetence of the government, or the ignorance of the consumer. But what if the past recession's root cause can be traced even further back?

To answer this question, let's take a trip back to the early 1980's. At this point in our country's history, we had just experienced nearly a decade of slow growth in real wages, rising inflation, a quadrupling of oil prices, and a doubling of interest rates to over 13%. Ronald Reagan had just been elected President, and Paul Volcker had taken the helm of the Federal Reserve. In Reagan's own words, it was "Morning in America": a time that often appears, in retrospect, to be the dawn of America's resurgence. But just how genuine was this resurgence? Was America really back on top? Or had we just entered into a Faustian bargain that, despite our perceived strength, would plunge us into the economic crisis we're experiencing today?

True, the world was quite different circa 1982. Credit cards were available but were not as ubiquitous as they are now. Cars were bought on time, homes were rented, and there was a "lay away" plan for items you wanted to purchase but could not immediately pay for. "Stagflation" was the buzzword of the day: real wages had not grown since 1975. While our nation's income statement may have looked poor, our balance sheet was in decent shape, and so was the consumer's.

From 1982 to 2008, the good times rolled or so it seemed. Our GDP grew by $10.8 trillion and Americans could look back on the Reagan administration as the first step on the road to prosperity. A closer look, however, may suggest the opposite. The 1980s were actually the starting point on the road to perdition: a journey that has taken us from a position of perceived invulnerability to a state of economic weakness from which, like the rest of the developed world, we are now desperately trying to recover.

Let's take a closer look at the numbers. In 1982, consumer debt was $1.6 trillion and federal government debt was $1.2 trillion. Consumer spending comprised 65% of GDP and the savings rate was 10%. Over the next two-and-a-half decades, consumer debt rose by $12 trillion and the federal debt rose by $9.5 trillion: a total of $21.5 trillion. During this same quarter century, GDP grew by $10.8 trillion: a number that seems large until you realize that, over this period, GDP grew only half as much as the sum of consumer and federal debt.

Figures 1 through 3 offer a more in-depth perspective. Figure 1 shows the growth in GDP, consumer debt and federal debt, respectively, from 1982 to 2008. Figures 2 and 3 portray the rise in consumption and the decline in consumer savings. Taken together, the data in these charts reveal that the entire increase in GDP was built on the simultaneous increase in leverage in these two dominant components of GDP. As we are all aware, this debt frenzy culminated in the recent subprime crises which in turn led to the global financial crisis. The strong consumer and government balance sheets are now gone. As a result, Americans are in for a long period of austerity and a major reset of expectations.

FIGURE 1: U.S. GDP, HOUSEHOLD AND GOVERNMENT DEBT

Source: Federal Reserve, June 2011

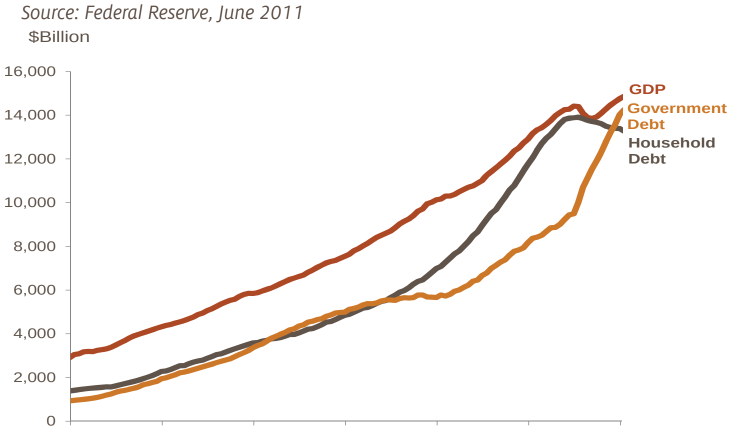


FIGURE 2: PERSONAL CONSUMPTION EXPENDITURES AS A PERCENT OF GDP

Source: Federal Reserve, Epoch Investment Partners, June 2011

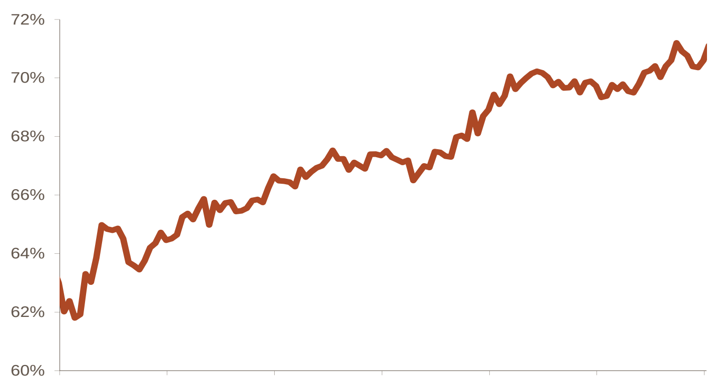
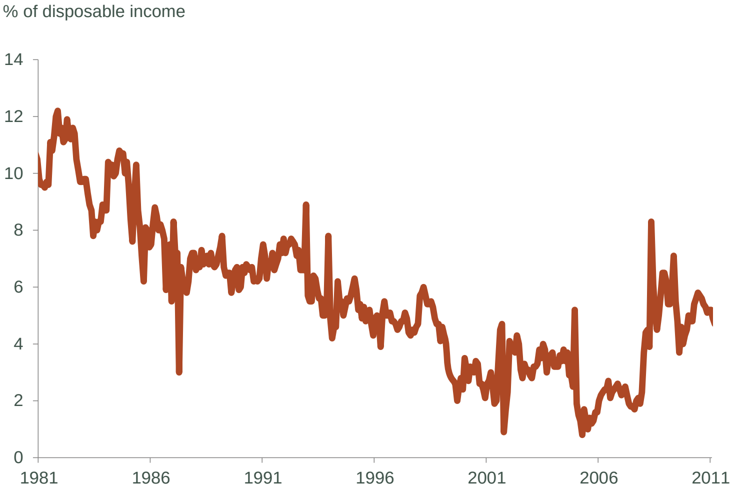


FIGURE 3: U.S. PERSONAL SAVING RATE

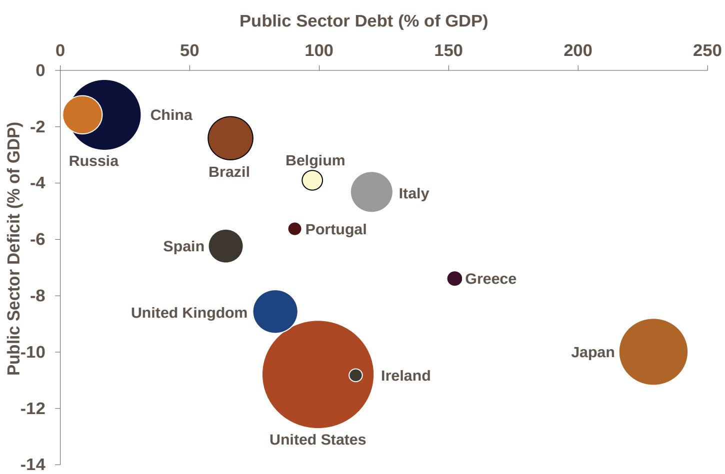
Source: Federal Reserve, June 2011



As for what this extended period of austerity will entail, it's clear that deleveraging in both the consumer and the government spheres must occur. If we don't unwind this debt, negative consequences are inevitable. Many countries throughout the developed world are in a similar position: they have already engaged in some form of austerity to deal with both their rising debt levels and, in the cases of Europe and Japan, poor demographics. Figure 4 illustrates this situation in detail. Unless effective policy shifts are made, these countries may suffer the same fate as Greece.

FIGURE 4: SOVEREIGN DEBT AND DEFICITS

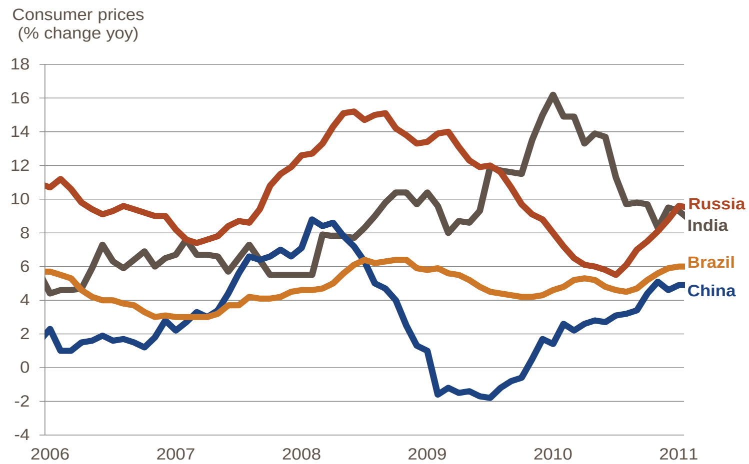
Source: IMF, Epoch Investment Partners; 2011



The emerging markets have also begun a period of austerity measures, but for different reasons. Their issue is inflation (see Figure 5). By pegging their currency to ours, China effectively imports the hugely expansionary U.S. monetary policy, which they attempt to offset by managing reserve requirements. This is just one of the many clumsy policy instruments wielded by the Chinese government, all of which are modified versions of the austerity objectives seen in developed nations. China's mercantile economic model must change to a model led by internal consumption, but that is easier said than done. A hard landing in China cannot be ruled out, which would spell trouble for the rest of the world.

FIGURE 5: GLOBAL INFLATION PATTERNS

Source: OECD, Bloomberg, April 2011



On the other hand, not everything in the emerging nations looks bleak. They have better balance sheets than the developed world, better demographics, better work ethics, and the financial wherewithal to improve their living standards. However, the rule of law in these countries is unevenly applied. Bribery and insider trading are rampant, and civil liberties are viewed as a nicety afforded by the West, but in many cases are neither wanted nor encouraged by the political leadership. Property rights, too, are a mixed bag.

So where do these trends take us? With austerity the policy of the day, the U.S. consumer must deleverage and so must the federal government. This means subpar growth in employment and modest gains in productivity. Those two elements (growth in the workforce plus productivity) define real GDP. In our view, the U.S. will have structural unemployment well above the 7% rate estimated by the San Francisco Fed, and quite possibly as high as 9% or 10% (see Michael Spence's paper in the July/August 2011 issue of *Foreign Affairs* for an eloquent discussion of the employment issue).

Europe's outlook is arguably worse. It is unclear whether or not the monetary union can be saved. The equity base supporting the European Central Bank's assets is only 3%, and the ECB values collateral at 100 cents on the dollar, so to speak. It appears, therefore, that a European banking crisis is almost unavoidable, and it could spill over into the U.S. through U.S. money market funds' ownership of European credit instruments and the credit default swaps written by U.S. financial institutions.

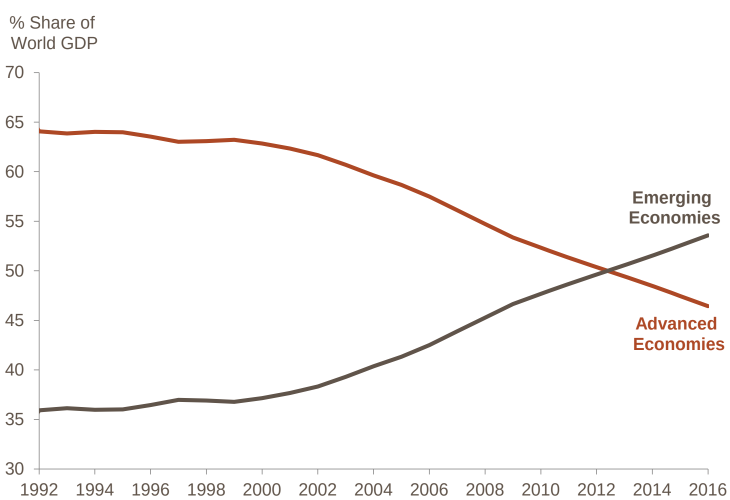
Can this situation be fixed? Yes, but only if the bad debt is extinguished. This can happen through growth — in which case the bad debt will recede in importance relative to the balance sheet as a whole — or the bad debt must be written off against today's equity. The problem is that European banks have too little equity to accommodate the write-offs required. A recapitalization of the banks is necessary to save the euro, and that will probably include steps that suggest a fiscal union of some sort. Otherwise, the euro could fall apart.

How might a solution come about? The treaties that bind the European Union require unanimous approval of member states for changes in guarantees; and unanimity, as we've seen in our own government, is difficult to come by these days. But if it could be shown that every country in the EU would suffer from the dissolution of the monetary arrangement, then perhaps grounds for a solution exist. The European Financial Stability Fund (EFSF) could be given the power to issue bonds underwritten in a pro rata fashion by all or some EU nations. If a debt instrument could be issued and also secured by the whole of Europe's balance sheet, the euro can be saved. If not, the euro may well fail and growth prospects would be severely harmed not only in Europe, but throughout the global economy.

As for investment opportunities, they do exist in the emerging world. But, as pointed out earlier, they are not without risk. Real GDP will grow much faster in the emerging nations than in the developed world. Figure 6 shows the changing composition of GDP between the G7 (a proxy for the developed world) and the other countries comprising the G20. As previously mentioned, the emerging nations of the G20 have solid balance sheets whereas the G7 nations do not. The former also have better demographics, a fierce desire to better their living standards, and a bursting pride in their national identity, as is particularly evident in China.

FIGURE 6: SHARE OF WORLD TOTAL GDP BASED ON PURCHASING POWER PARITY (PPP)

Source: IMF, World Economic Outlook Database, Epoch Investment Partners, April 2011



In the very short run, bonds may well outperform equities as the resetting of expectations takes place and volatility in the capital markets rises. But if one's time horizon is measured in years and not months, equities should trounce bond returns. Earnings yields today vastly exceed bond yields, and corporate balance sheets remain very strong. Equities also capture productivity gains and provide a hedge against inflation through their ability to ultimately pass along price increases in the factor costs of production they encounter. No matter what your time horizon, bonds do not provide that kind of protection.

With return expectations for equities undergoing a reset — reflecting a slower growth rate for the global economy over the next few years from the effects of deleveraging by the developed world's consumers and governments — we believe the strategies that will work will be global in nature and will emphasize dividends in the forms of cash, share buybacks, and debt repayments. These will include companies that are considered global champions, based on free cash flow measures, which are managed by leaders with a history of wise capital allocation.