Sauberan & Co.

October, 2009

ECONOMIC OUTLOOK

This recession has been frequently referred to as a "financial crisis" however the economic challenge is significantly broader than dealing with record losses at the banks. Extended periods of low interest rates, accommodative fiscal policies and financial engineering have combined to delay the deflationary effects of globalization and technology. Although we experienced periods of growth, the benefits have proven to be temporary and expensive. More importantly, the combined effects have led to significant imbalances in the global economy contributing to the worst economic crisis since the 1930's. At a conference of the world's leading economists in August 2003 at Jackson Hole, Wyoming Bill White and Claudio Borio, the two most senior economists at the Bank of International Settlement (BIS), presented a paper warning that not all financial innovation was good. Their paper was met with much skepticism and the Federal Reserve asked the economists to "tone down" their report. The concern was with the correlation of all asset classes around the world rising simultaneously. Normally, bonds and stocks move inversely, commodities and bonds move inversely, and commodities and equities (at least in the U.S.) tend to move inversely and yet, all these asset classes were rallying at the same time. The distortion was a result of debt/credit increasing much faster than economic growth and the excess capital (leverage) seeking investment returns. This in turn artificially drove up stocks, bonds, real estate and commodities.

From late 2002 to late 2007 most of the world's major stock markets rose more than 90% with a few up more than 200%, a correlation never seen before. The same rapid appreciation occurred in global real estate markets as prices increased 100% – 200% or more in some of the hottest markets like Britain, Ireland, Spain and Central Europe. In 2005 Ben Bernanke, attempting to justify the rapid appreciation, said "*House prices (in the US) have risen nearly 25% over the past two years. Although speculative activity has increased in some areas these price increases largely reflect strong economic fundamentals, including robust growth in jobs and incomes…*" Not to be left out, many commodities too saw prices double and/or triple with oil topping out in the summer of 2008 up 500%.

Central Bankers failed to recognize the danger as their economic models focused on consumer prices which didn't consider asset prices. Under Ronald Reagan, the Bureau of Labor Statistics (BLS) decided that housing was overstating the Consumer Price Index (CPI) and substituted an entirely different Owner Equivalent Rent (OER) measurement, based on what a homeowner might get for renting his house. This methodology, controversial at the time and still used today, sidesteps what is happening in the real world of homeowner costs. This change was significant because the cost of owning and/or renting a home is 40% of CPI, the largest component. By excluding homeowner costs, US consumer prices have increased at a modest 2.5% annual rate since the mid 1990's, substantially slower than the rise in asset prices. If CPI had been calculated using homeowner costs instead of rent, inflation over the last 10 years would have been 8-9% and most certainly the Fed's monetary policy would have been more restrictive. Conversely, with housing prices down substantially over the past 2 years CPI understates the current level of deflation. Even without using homeowner costs to calculate CPI it's down -1.3%, the first annual decline in inflation since the early 1950's.

By 2007 the New York Fed Bank estimated that financial innovation had propelled assets held in the lightly regulated and highly leveraged "Shadow Banking System" to $8 trillion. In comparison, the 8,000 regulated US banks held combined assets of $10 trillion, incredibly 45% of the assets in the financial systems were outside supervision of the bank regulators. Much of the growth in the "Shadow Banking System" was intended to avoid reserve requirements and allow US financial institutions to be more competitive with European Banks. With more lenient reserve requirements European Banks are able to take more risk than US banks. In 2004 the SEC issued exemptions from bank reserve requirements to the five investment banks (IB), Goldman, Bear, Lehman, Merrill and Morgan Stanley permitting them to increase risk. In 2006 the SEC issued a second exemption this time allowing the IB's to increase risk to 30x assets. More important, the SEC deferred the responsibility of monitoring risk at the IB's to the banks own internal "value at risk systems" (VAR). By December 2007 the five IB's controlled $4 trillion of assets unregulated by the Federal Reserve and the SEC. As we all know, the excessive risk didn't work out well and required unprecedented support from the Federal Reserve which continues today. At the same time, banking regulators and the Federal Reserve allowed commercial banks to take more risk by moving some $2 trillion to off balance sheet businesses in order to avoid bank reserve requirements. With commercial bank losses exceeding $800 billion and still mounting, the total costs are not yet known. Elsewhere the government "sponsored" mortgage giants "Freddie" and "Fannie" guaranteed $5 trillion in mortgages, but were only required to hold reserves of

$50 billion (1%). With mortgage default rates above 12% the government has placed "Freddie" and "Fannie" into conservatorship and transferred $100 billion to cover losses that may eventually exceed $1 trillion. Similarly, the Federal Deposit Insurance Corporation (FDIC) insures over $6 trillion in bank assets with only $75 billion (1.5%) in reserves. Since January 2008 the FDIC has closed 140 banks and in the process using 100% of its reserves. With zero reserves and another 475 banks on its "watch list" the FDIC is looking for solutions to rebuild the deposit insurance fund. The Federal Reserve expressed little concern for the excessive risk in the financial system and the rapid rise in asset prices. Greenspan, a champion of free markets, was confident that the dramatic increase in derivatives had sufficiently spread the risk among the financial institutions.

Conventional wisdom postulated that the tremendous growth in the financial system reflected an economic transformation from a manufacturing economy to a service economy. However, current events are exposing the short term benefits and the long term costs of that belief. This decade GDP increased $4.8 trillion while debt increased $26 trillion costing $5.47 for each $1 of economic growth; this is twice what growth cost in the 1980's. Total debt in the economy is now 33% higher than the debt level that led to the economic crash in 1929. The greater cost of growth reflects more consumption than production, transferring our wealth to higher producing countries. Globalization and technology shift capital and production to lower cost regions of the world. Given the extreme level of debt, the increase in asset prices is temporary as wage and job growth hasn't kept pace with the debt acquired to support asset prices. This is reflected in the significant declines in all asset classes. Including the recent market recovery, the stock markets as well as commercial and residential property prices all remain 35% below their highs. Since late 2007 the combined net worth of the US population has declined $14 trillion while total debt in the economy, due to government spending, continues to grow.

It might be plausible to accept higher debt levels if there were job and wage growth; however, that has not been the case. The economy has created zero jobs this decade, there were 131 million employed in January 2000 and there are still only 131 million employed in September 2009. Just as important, wages adjusted for inflation are at the same level as they were in 1998. In comparison to previous decades, the economy should have added 26 million jobs the past 10 years. The lack of job and wage growth has been masked over by the consumers' willingness to forego savings and increase debt. In the past 10 years savings has fallen to zero while personal debt has doubled, in 1980 debt to income was 60%, today it's 130%.

However, the imbalances in the economy are unsustainable. Economic growth and asset prices depend heavily on over consumption. In 2008 consumer spending peaked at 70% of the economy, 10% ($1.4 trillion) above the historic average and driving corporate profits 50% above their historical average. With the recent decline in asset values and significant job losses, consumers are becoming uncharacteristically more conservative. Job losses have reduced annual income by $500b, the decline in real estate prices has reduced annual profits and/or equity withdrawal by $500b, and consumers are currently saving $500b per year while also paying down debt at an annual rate of $250b, a net change of $500b, all of which add up to $2 trillion less in consumer spending. Rather than accept the reduced consumer spending, government officials have initiated an unprecedented level of stimulus to support asset prices and encourage more spending. The government is attempting to solve too much debt with more debt, spending taxpayer money that taxpayers are unwilling to spend. Yet, virtually no action has been taken to correct the imbalances in the economy that have led to this crisis, we operate under a policy of "pretend and extend." Meanwhile, the very government officials who never saw the economic crisis coming are now telling us the worst is over.

Albert Einstein – definition of insanity - "We can't solve problems by using the same kind of thinking we used when we created them."