

VOLUME 12
ISSUE 1
JANUARY 8, 2010

INSIDE

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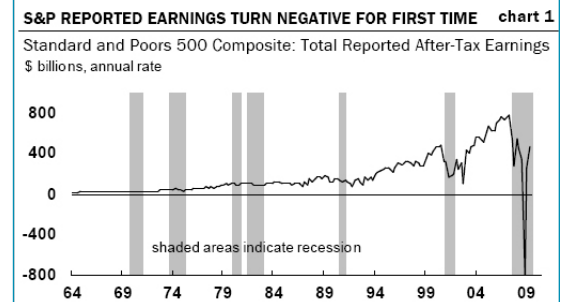
The 2010s

Getting The New Abnormal All Wrong

Last June, we noted that many government officials, financial leaders, and various experts, who had admitted being dumbfounded by events at the height of the crisis, had since developed supreme confidence in their diagnoses and prescriptions for the economy. Unfortunately, neither opinion leaders nor the general population have much awareness of either the macroeconomic processes behind the events of the past two years or the challenges ahead. Most investors are going to make decisions based on the expectation of a return to normalcy, and they are going to get it wrong in the years ahead.

Since the popular economic frameworks lack the wherewithal to explain (or even accept the existence of) the severe financial instability of these times, some creative analysts have come up with new names and concepts that attempt to at least describe it. Today, there are two especially popular labels, one looking backward and one looking forward: “the Great Recession” and “the new normal.”

We have been asked, “You guys predicted the Great Recession, so now are you in the new normal camp, expecting slow growth?” No, we are not. Actually, our forecast was for a secular reversal of the big balance sheet economy trends, which would involve multiple recessions, including the first, severe one. And to suggest that the contained depression is merely a period of slow growth is grossly inadequate. Distinguishing between what just happened and the Great Recession and between our outlook and the new normal scenario reveals several important distinctions for policy makers,



investors and for business planners.

So What's a Great Recession?

The Great Recession, it turns out, is a name that has been stamped on a number of recessions over the years by various parties. *Forbes*, *Newsweek*, and *The New York Times* all used the term to describe the mid 1970s recession. The term was reapplied to the 1980s “double-dip” recessions, occasionally to the 1990s recession and aftermath, and . . . well, you get the picture. So Great Recession means “recession that strikes someone as being really bad, or the worst since the 1930s, or the worst he remembers.” Based on that definition, the slump that began in December of 2007 certainly was a Great Recession, given the declines in profits, output, employment, investment, and production.

But does that label provide any insight into the forces behind it? No, the public is no more enlightened now than a year ago. To simply sum up the episode as an especially bad recession without noting the watershed reversal in balance sheet expansion and its dire implications for profits is to say little of substance. No, this was not just a bad recession, and there were

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lots of clues that something unusual was going on.

1. Net private investment did not merely have a cyclical decline. It ceased.
2. S&P profits – both the reported and operating earnings – completely collapsed, to below zero for the first time ever (chart 1, on page 1).
3. Household wealth as a percentage of disposable personal income experienced by far its greatest decline of the postwar era (chart 3, below). The total value of household sector real estate fell severely; previously, it had never fallen at all.
4. Nonfederal debt fell for the first time since the flow of funds began in 1952. In fact, so did total private debt, private nonfinancial sector debt, financial sector debt, and household debt, among other categories.
5. For the first time, the Fed ran out of room to cut interest rates and could not bring them down far enough to relieve many of the debt problems.
6. The entire banking system would have collapsed but for extraordinary government lender-of-last-resort actions.

Not Much Will Be Normal About the 2010s

Many people recognize that the economy may be slowed by “headwinds” caused by consumers saving more and banks deleveraging, but they think that is taken into account under the label, “the new normal.”

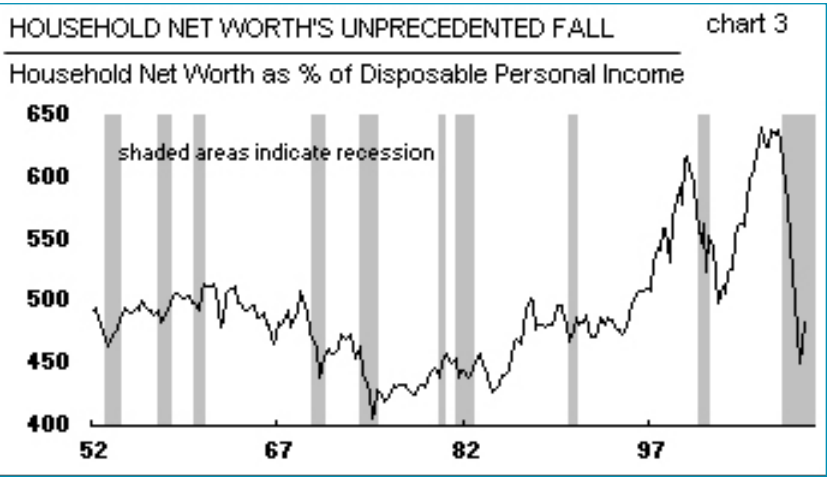
The new normal has evolved to mean, in general usage, slow growth but otherwise familiar cyclical patterns. Instead of real GDP growth averaging about 3% annually as during the past 30 years, it will allegedly average about 2% for a number of years (chart 2, page 3). So, many people seem to think, one can expect an economy that looks much the same, just growing at two-thirds the pace—the same old movie shown at a slightly slower speed. Inflation, interest rates, and other features of past cycles will pick up with the expansion and fall if there is another recession later, much as in the past.

Taking that prognosis to heart would leave one dangerously unpre-

pared for what lies ahead during the 2010s.

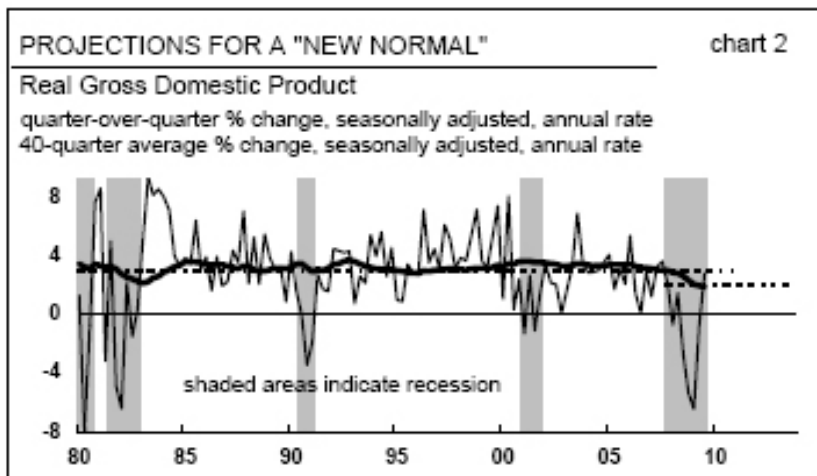
Here’s What The “New Abnormal” Will Look Like

1. Consumer price inflation will fade away, giving way to periods of deflation.
2. Unemployment will be chronically high, averaging 8% of the labor force or more over the next decade.
3. The average pay raise will keep dwindling, maybe vanishing altogether. Already pay cuts have become common, affecting an increasing share of the working population.
4. Deflating average pay, plus persisting, severe unemployment, add up to worsening household debt service problems and worse loan performance than lenders and the government are anticipating.
5. The worst of the mortgage derivatives crisis may be over, but the mortgage default crisis is still developing and will become much worse.
6. Private credit extension will remain stunted.
7. Asset prices will remain on secular declines. Prices of real estate, corporate equities, risky debt instruments, tangible business assets, trademarks, patents, art, antiquities, and so forth will bounce around but end up considerably lower than they are now. A notable exception: The prices of Treasury bonds and, likely, some top-quality corporate bonds.
8. There will be increased economic volatility; expansions will tend to be shorter and recessions to be more disruptive than in early post-war cycles.
9. International relations are likely to deteriorate as government officials around the world struggle to stay in power in the face of severe public dissatisfaction with the economy. Popular protectionist sentiment will increase, and with already big government deficits and low interest rates, leaders will find it more difficult to find internal solutions than to blame



Avg. Real GDP Growth: An Almost Worthless Descriptor

The 10-year average growth rate stayed close to 3% over the past 30 years, but it was hardly illustrative of the state of the economy. Many expect growth to average about 2% in the period ahead. Whatever the average turns out to be, it is likely to be even less descriptive in a period of higher volatility, financial instability, and deflation.



foreign firms and governments for the malaise. Cooperating on noneconomic issues, such as terrorism, the spread of nuclear arms to unstable dictatorships, and global warming, may be compromised as well.

10. Federal deficits will not shrink back to a few percent of GDP; trillion-dollar deficits are likely to persist for years.

11. The Fed may craft a comprehensive exit strategy from extremely easy monetary policy, but, if so, it will stay on the shelf collecting dust for a long, long time.

12. Domestic political upheaval is probable: when no one is happy with the economy, people will want change. Scapegoating will flourish.

13. There will be no monolithic emerging market economic boom. At best, some EMCs will remain overly dependent on exports to the United States, Europe, and Japan, and

they will stumble. At worst, a sweeping global financial crisis and economic instability in countries that might include Russia or China will cause a severe global decline.

Investors should take these warnings seriously; there are more "100-year storms" to come. Strategies ranging from shorting volatility to buying assets in expectation of cyclical appreciation could lead to trouble. Government must be viewed as a much more important influence on the economy and the financial system than in the past. Many surprises lie ahead.

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