

Issues for National Conference Call on Tuesday, September 27, 2011
Topic: "Fragile Times"

Question 1:

Has the U.S. economy weakened since last spring?

There is no doubt that the U.S. economy looks weaker today than in the spring.

In July, the U.S. Commerce Department published revised estimates of the GDP growth over the last few years. Before the estimates were released, we ***thought*** that we had grown 1.9 % in the first quarter of this year. Instead, we learned that we had grown ***only 0.4 %*** that quarter and only 1.0 % in the second quarter. Similarly, growth during the recession was also revised downward. It was a big shock. The new figures help to explain why job growth has been so slow.

A second reason is that ***business investment is still depressed***. In the spring, many of us thought that investment would start to rebound because consumers were showing signs of life. But businesses are still sitting tight.

A third reason for a more subdued outlook is that the ***European crisis looks worse*** than we originally thought.

Question 2:

Why hasn't business investment picked up?

Normally, firms start to increase their investment early in the economic recovery. But this time, investment remains ***12 % below its peak in 2006***. Among the reasons, two stand out.

- 1) ***Firms are not investing in real estate***. Firms normally start spending on office buildings, factories, distribution facilities early in the recovery. They want to be ready as consumer demand and exports rise. This time, we had just been through a commercial real estate boom. ***There is excess capacity in commercial real estate***. So we are getting no boost in investment there.
- 2) Second, firms are having trouble getting bank financing for investment. Commercial and industrial loans are still ***19 % below where they were in 2008***. And real estate loans have not even begun to recover. Firms,

especially small and medium size firms, are short of capital. And the banks are not helping.

Business investment is the one source of aggregate demand that has not recovered to pre-crisis levels. Consumption is back where it was and so are exports. But firms are holding back from investment.

Question 3:

Why is the U.S. economy not recovering from the recession like it normally does?

I think the proper answer is that ***“This Time is Different”***

That’s the title of a book by Reinhart and Rogoff that studies past financial crises like the one that we just went through. Financial crises leave banks and firms and households so weak that recovery is slow and weak. Banks have weakened balance sheets and a legacy of fear that limits lending when the economy begins to recover. ***Firms can’t get bank financing.*** Households are crippled by past debt and feel so much poorer after real estate values have tumbled. After a financial crisis, it just takes much more time for recovery:

According to Reinhart and Rogoff, after a financial crisis

1. It takes an average of **six years** for housing prices to stop falling
2. Unemployment stays high for **five years.**
3. Government debt increases by an average of 86 %

So it truly is “different this time”.

Question 4:

Does that help explain why business investment remains depressed?

Yes, I think it does. One key result of the Reinhart-Rogoff study is that **financial crises cripple banks.** As a result, **banks become far more reluctant to lend than in the past.** So firms have been unable to finance as much investment as they normally would.

Let me give you a startling statistic to buttress this point. Normally cash at commercial banks is of the order of \$ 400 billion. ***Today, cash totals about \$ 2***

trillion. (These are figures from the Federal Reserve). This excessive cash could be put to work in business loans financing investment. But banks that have just been through a financial crisis are not willing to lend to firms like they normally do. So business investment stays low.

Question 5:

Explain the Federal Reserve's new policy announced last week.

Last week, the Fed announced that it would start buying long term Treasury bonds in order to boost their prices and lower yields. The aim of the policy is to lower yields on all types of long-term bonds including corporate bonds and mortgage bonds in order to spur economic growth.

“Operation Twist”. Because the Fed does not want to increase the total size of its Treasury holdings, it intends to fund its **purchases** of long term Treasuries (10 to 30 years) with **sale** of short term Treasuries (less than 5 years). This operation was first tried in the early 1960s under President Kennedy (when a popular dance was called the “Twist”).

Will it work? It's important to realize that long term yields are **already incredibly low**. Last week before “Operation Twist” was announced, the 30 year Treasury had an interest rate of 3.2 % and the 10 year Treasury had an interest rate less than 2 %. You have to go back to the days of President Eisenhower in the 1950s to find interest rates this low. So even if it does lower yields at the long end, ***its impact will be minimal.***

Question 6:

What does this all mean for stock market investments?

Even with the last couple of months of poor stock returns, the S&P 500 is still up over 65% from its lows in 2009. I have highlighted the disappointing features of the recovery. But the U.S. economy is still recovering. And as the recovery continues, we will see further returns from equities.

That's not to deny that the U.S. economy remains vulnerable to a new setback. We are growing so slowly that we remain vulnerable. But I am looking two to three years ahead. I can see the deleveraging process coming to an end with the

resumption of a higher growth rate in the United States. As this occurs, equity investors will inevitably be rewarded for owning stocks. We just have to be patient.

Question 7:

What's wrong with Europe?

We have known for a year and a half that the Greek government needs substantial support because its government is running such a huge deficit. And we have known for over a year that other countries like Ireland and Portugal also are in trouble. In fact, the term "PIIGS" was coined over a year ago to identify the five countries that need help in their fiscal affairs: Portugal, Ireland, Italy, Greece and Spain.

But now we understand better how difficult it will be to straighten fiscal affairs out in Europe.

- 1) First, we now see **how reluctant** the healthier northern European countries like Germany, Finland, etc. are to bail out their weaker brothers. There is a **lot of resentment** against countries that have been fiscally reckless.
- 2) On the other hand, **banks** in Germany, France, and other stronger countries hold lots of debt in the five "PIIGS" countries. So the northern European countries are reluctant to cut Greece and other countries off from credit. Europeans genuinely fear a "Lehman type" crisis where default in Greece leads to a run on banks and a financial crisis in Europe.
- 3) Because there is no easy solution to this crisis, the **Euro area muddles on.** This has raised risk premiums in Europe. In fact, Greek government bonds have such a high yield that the market clearly thinks that default is almost inevitable at some time in the near future.

All of this creates risk for U.S. firms and banks.

Question 8:

But surely U.S. banks don't hold Greek bonds, do they?

U.S. banks hold very little Greek debt. But U.S. banks have deep ties with the leading European banks. So they would suffer if there were a general crisis in Europe. And even "safe" money market funds could suffer because they currently

hold a lot of short term debt issued by leading European banks. We live in an interconnected world.

Question 9:

What can an investor do to protect against European risks?

The prudent thing to do is to reduce exposure to European stocks. But don't go overboard. Remember that countries like Germany are still doing relatively well. Germany's exports to their Euro area trade partners are setting records. And Germany is still benefitting from growth in Asia. This is also true of some of its neighbors like the Netherlands. And throughout Europe there are some great companies that are more attractive than normally because of the sell off of European stocks. So find a good manager who can navigate well in Europe.

Question 10:

You provide investment advice to several wealthy families. What are such families doing with their portfolios?

I advise family offices that control hundreds of millions of investable assets. I don't see any panic at all in these families.

They have a target portfolio that spreads their investments over different types of stocks including foreign stocks. And they have diversified portfolios of bonds, always paying attention to credit risk. And, because the families are very wealthy, they have investments in private equity and hedge funds. Like many families with more modest wealth, they invest in real estate. Throughout the financial crisis and recession, they did not panic. And now they are just being patient waiting for the U.S. and world economies to recover. They are investing for the long run. That makes sense for you and me as well.