

INSIGHTS ON FRONT STREET



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THE SLOWING SPEED OF DESCENT

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In an economy such as this, it's wise to see things with the end in mind and invest accordingly. For many decades, our economy was propelled along by the steady winds of easier and easier credit. Those winds have stopped blowing at our backs and are now hitting us right in the face. Eventually, the road of debt accumulation ends and you have to begin the journey back. Our economy is on this journey called "deleveraging".

Things always start out innocently enough. With asset prices rising higher and higher, having enough income to pay the interest *and* principal back became less and less important. Just being able to refinance the debts at lower interest rates was the name of the game. Borrowers were figuratively kicking the can down a road that seemed to have no end in sight. Then, as the debt load mounts, it became increasingly difficult for consumers to pay even just the interest due. At this point, consumers were then generously treated to "cash-out" mortgage refinancing, easy to access home equity lines of credit and unbelievable offers for balance transfers to credit cards that promised rock-bottom rates.

Then, with little advance warning - or warnings that are easy enough to ignore - a small shift in sentiment occurs and the bubble pops. Today, *after the pop*, our focus is on how to invest as our economy travels this path of deleveraging. We think it's important to analyze any recovery's start with the end firmly in mind.

It's clarifying to note that the ongoing process that's now underway was *not caused* by the panicky seizure of the financial system this past fall. The first cracks appeared a full year before the "meltdown", in August '07. It was only when enough people recognized that the music had indeed stopped that people ran for the exits in September '08. The credit freeze-up exacerbated something that already existed.

For investors today, we think it's imperative to recognize that the absence or relieving of a credit panic does not mean the recession will be short lived. It just means that the speed of the descent is slowing by comparison. We are being very cautious in our interpretation of this "less bad" economic data.

Widespread consumer deleveraging naturally takes time and "fixing our economy" is going to feel a lot like trying to get a bonfire going when you only have wet logs to burn. The data shows that households are mired in the hard slog of debt reduction. Understanding this scope of this phenomenon might help one better understand why the governments, globally, are reacting so aggressively. It is a massive journey and it is still in its early stages.

To put things into perspective, US households now owe about \$14 trillion dollars, collectively. These are consumer loans, such as home mortgages, second mortgages, home equity lines, car loans and leases, credit card debts, student loans, and various other unsecured consumer loans. These loan types are now part of our culture's very fabric. However, they were not always so accepted as the norm. It took an attitude shift and these shifts take time.

As a percentage of our nation's annual economic output (GDP), this debt represents about 100% of GDP. As recently as a decade ago this represented less than 70% of GDP. And, going back to the early 80's, household debt-to-GDP was at about 50%. In about only one

generation, households in the US have *doubled* their debts. This was a huge borrowing binge and, eerily, it parallels the doubling of household debt in the 15-20 years before 1930. This is yet another ugly comparison to the Great Depression.

A modern-day historical range of household debt-to-GDP ratio is about 50%-70%. To get back to this level, over time, we should expect that consumers will either (a) save money to pay down debt, (b) sell assets to pay down debt or (c) restructure their debt via bankruptcy or debt forgiveness. In aggregate, it wouldn't be crazy to imagine that household debt declines, over time, by around \$3-\$5 trillion. Of course, the GDP will likely grow over time as well - albeit possibly more slowly than we're used to - and this will alleviate some of the pain.

However, there is no pain-free path to deleveraging. The process is carried out at the individual level with households making decisions that are best for them alone. This creates a classic paradox where we all might end up collectively less well off. This paradox helps explain the inherently contradictory pleadings for banks to lend and for consumers to spend. The authorities know the journey is underway and they are trying to just slow it down and stretch it out. They would never admit this, of course. "Slow and stretch!" is not as good a campaign slogan as "Recovery around the bend!"

Of course, our challenge is to judge the effects of this deleveraging journey as it relates to individual stock prices. In the end, price is the great equalizer of risk.

We are well aware that the economy's recovery will come after the bottom occurs for capital markets. Stock markets are forward-looking institutions. So, this means investors are prone to being tormented at or near the market bottom. It is rarely an obvious moment. It is all about shades of dark and faint glimmers of hope.

To help guide us in our judgments, we see four things that are concerning and lead us to believe that investors have not "factored" it all in quite yet.

First, household net worth dropped \$11 trillion in 2008 alone. The combination of housing price declines and investment losses is simply massive in scale. In fact, housing prices probably have a good amount more to fall. We also feel that baby boomers have been dealt a severe blow and unless their investments miraculously recover (and soon!), their decreased propensity to spend and their increased savings rate will create very strong headwinds for any economic recovery.

Second, the availability of credit is going to continue to decline for consumers and businesses. Our house-

hold sector built up nearly \$7 trillion dollars of debt from 2000 to 2007. As noted above, over the next decade we could see an actual reduction of \$3-\$5 trillion of household debt. With 70% of our GDP dependent on consumer spending, a decline of spendable dollars of this magnitude is not inconsequential. This drag could put a lid on the recovery's growth and we think this might dampen the overall enthusiasm for stocks as well.

Third, interest rates are at abnormally low levels and we've accumulated a serious mountain of debt along the way. The Federal Reserve has started creating money from thin air and they've begun buying our own government's debt with it. It's not totally clear that these unconventional actions are going to lower interest rates much more. It is like trying to hold a basketball under water. The deeper you take it the harder it becomes to hold down. It is our view that a recovery could bring with it higher interest rates than we're seeing today. This, too, could affect the type of recovery we'll eventually see.

Fourth, unemployment is going to keep rising for a while yet. Lately, the jobs data are brushed off as just lagging indicators of an economic recovery. We know the economy typically bottoms before the unemployment rate begins to recover. However, in this type of debt induced recession, job losses negatively feed back in real-time. Capital starved banks know this. Debt strapped households know this. Consumer dependent companies know this as well. In this environment, job losses are bringing distressed borrowers to their knees and are resulting in ever more mortgage foreclosures and personal bankruptcies.

With this process underway, and despite the much lower prices of stocks, we don't think there is any rush to buy into an anticipated market recovery. We've been saying all along that this market is unlikely to run away from us. Eventually, we know that prices will be too low to pass up any longer. But, patience is still our mantra as hard as these market rallies are to stomach.

In many ways, the discipline we've shown so far in this wrenching cycle will be even greater during the next stage. While the economy may no longer be following such a rapid and panicky descent, it is becoming more evident to us that these "glimmers of hope" and "less bad" data points are simply a matter of people settling into a new phase of their uncomfortable deleveraging journey.



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