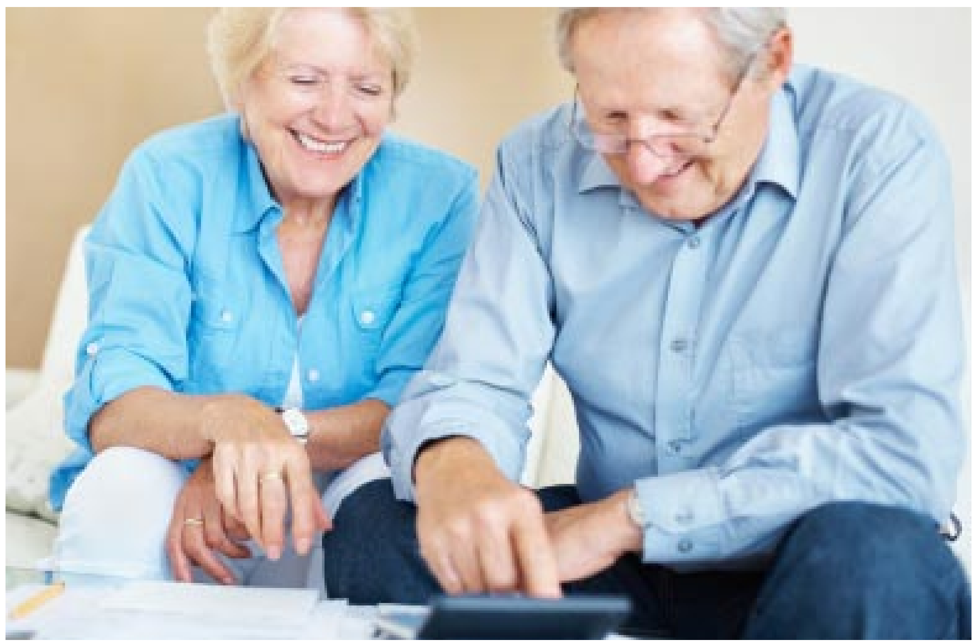
SIGNATUREFD

ECONOMIC OUTLOOK: THE DEBT SUPERCYCLE

A SIGNATUREFD WHITEPAPER

abstract

The last seventy years have seen tremendous growth and advancement in the size and diversity of the U.S. economy. By almost any measure we are more prosperous, innovative, and advanced than we were in 1950. That said, we are clearly at an inflection point and the trends that allowed for much of this advancement are no longer working. For several decades the Debt Supercycle helped increase our national wealth as high savings, investment, and innovation led to a rising standard of living. But at some point in the last decade, the cycle that was turning in a positive direction reached its limits and began to reverse. As such, the current downturn is different than those we have witnessed since World War II, significantly because of this process of debt reduction.



In this first segment of a multi-part white paper series we introduce four key elements of the current economic environment:

- What is the Debt Supercycle?
- Can history teach us something about the current period of debt reduction?
- What are the true debt statistics and how are they affecting economic growth?
- How has the involvement of governments and central banks impacted the current cycle?

At SignatureFD, we try to understand and interpret the world we are living in with the underlying goal of helping each of our clients live a confident, full, and purposeful life. Living in a period of dramatic change makes these aspirations difficult, but we believe it is important to try to gain a greater sense of the world around us not only for our personal well-being, but also as part of creating a well designed financial and investment plan. We hope you find the discussion informative and thought provoking.

THE BOTTOM-LINE IS THAT THE TRADITIONAL CYCLE CAN BE ELONGATED AND MANAGED, BUT NOT COMPLETELY DONE AWAY WITH.

WHAT IS THE DEBT SUPERCYCLE?

Without a doubt, the economic progress of the U.S. from World War II through the end of the twentieth century was likely the greatest advancement of living standards in human history. Short periods of gloom were interspersed throughout that time, but they were generally brief, and when we view them from the perspective of history, they were only small set-backs within the bigger positive trend. Much of this great economic story was based on fundamental strengths and the enduring decisions of our parents and grandparents. A tradition of education, savings, investing, and innovation allowed us to compound real income gains and wealth creation over multiple generations. However, some of our story is the result of a more modern phenomenon that made it look even better than it really was - the Debt Supercycle. The theory of the Debt Supercycle comes from the Canadian economic research group, Bank Credit Analyst (BCA). Here is a brief description of the theory, in their words:

> *The Debt Supercycle is a description of the long-term decline in balance sheet liquidity and rise in indebtedness during the post-WWII period. Economic expansions have always been associated with a buildup of leverage. However, prior to the introduction of automatic stabilizers such as the welfare state and deposit insurance, balance sheet excesses tended to be fully unwound during economic downturns, albeit at the cost of severe declines in activity.*

Government policies to smooth out the business cycle were successful in preventing the frequent depressions that plagued the pre-WWII economy, but the downside was that the balance sheet imbalances and financial excesses built up during each expansion phase were never fully unwound[1].

Step back for a minute and compare this to the natural economic cycle that existed for a couple hundred years before the Great Depression and World War II. Historically, an economic cycle starts with small amounts of debt and as the economy expands, debt grows, positively pushing the growth along. Eventually a 'boom' period occurs and then as debt levels peak, the cycle moves into reverse with debt declining as the economy shrinks, and the proverbial 'bust' occurs. But the Supercycle theory says that government policies put in place to smooth out the natural cycle now allow for the 'boom periods' to exist without the historic pattern of 'bust periods' to cleanse the system. Clearly, if it was possible to have the growth without the corrections this would be a good thing. However, this makes the issue seem simpler than it really is. Taken over multiple cycles, this trend leads to a large amount of debt held in the financial system, by consumers, and at the government level. The bottom-line is that the traditional cycle can be elongated and managed, but not completely done away with.

IT APPEARS THAT THE MARKET IS NOW REVOLTING AGAINST THE ATTEMPTS BY POLICYMAKERS TO MAINTAIN AND SOLVE THE DEBT CRISIS WITH ADDITIONAL DEBT.

This is not a complicated idea; we all deal with it on a daily basis in our personal finances. If we spend more than we make, we're borrowing money, either from ourselves or from someone else. And if we don't pay it back while continuing to outspend our income, our imbalance grows and it is harder and harder to get back to equilibrium. The question is, *when does debt move from being a useful and productive tool to one that has negative implications?*

We think that over the past decade we have reached that point. It appears that the market is now revolting against the attempts by policymakers to maintain and solve the debt crisis with additional debt. Beginning in 2007, it appears that the inflection point was reached for the private economy and, though not yet a certainty, we suspect that this point is happening now in the government sector seen both in the crisis in Europe and the battles domestically regarding the budget debate and debt limits.

IS IT DIFFERENT THIS TIME?

Carmen Reinhart and Kenneth Rogoff authored a book titled This Time is Different[2], which was first published in 2009. This book is one of the most important economic compilations of this generation and provides critical historic context for what we are going through today. It is not for the faint of heart - providing detailed analytics and observations on 300 financial crises over an 800 year period. However, the pattern of these previous economic periods will sound all too familiar. First, the data showed that during the initial phase of a crisis, housing prices drop an average of 35% and stock prices drop an average of 56%. Second, because of their natural instinct of stepping in to help the private sector, government debt nearly doubles which eventually slows economic growth. And finally, because of the increased government debts, the crisis is typically followed by a period of national and political challenges, including concerns over budget deficits, sovereign debt, and currencies. The analysis showed that these final issues begin appearing approximately 3 years after the initial financial crisis.

The book by Reinhart and Rogoff is in many ways just a compilation of historic periods of deleveraging. Deleveraging sounds like a geeky economic term, but in its simplest form, it is just the paying down of debt. When applied to the macro economy, it is indicative of the total amount of debt compared to total income being in a period of decline. Again, in the context of household finance, it is similar to taking out a home equity loan to pay for an addition to your house. Once the project is complete and payments commence, you are undergoing a form of deleveraging — debt was used to increase the value of an asset, with the debt being paid down out of income over time.

A report by business consulting group McKinsey and Company confirms much of Reinhart and Rogoff's work. Their findings show that a long period of deleveraging nearly always follows a major financial crisis. On average this debt contraction starts about two years after the crisis and can last as long as six or seven years. In the end, debt compared to GDP drops by an average of 25%[3].

So a review of history shows us that even though the current economic climate appears unique, there is historic precedent for what we are living through. Even though most current adults haven't confronted a similar set of circumstances, there is some comfort that our forebearers did successfully deal with and survive similar challenges. As McKinsey & Company concluded in their excellent paper, "In our research into historic episodes of deleveraging, we see that countries often progress through two distinct, yet overlapping, phases of private (household and business)— and public(government) sector deleveraging. Today's deleveraging economies face what seems to be a uniquely difficult situation: a weak global economy, banking troubles across many major economies, and little room for fiscal maneuvering. Yet, they share many of the same challenges that faced deleveraging nations in the past.[4]"

WHAT IS THE TRUTH ABOUT TODAY?

It is important to get a sense of where debt levels reside and how they have been trending in recent years. The statistic that most analysts look at when measuring debt is the **Debt to GDP (Gross Domestic Product) ratio**. This is essentially the total amount of our collective debt compared to the size of the gross domestic economy. The size of the economy, measured by the GDP, is roughly equal to the combined income of all consumers - think of it as the national income. Just as with our personal finances, while assets can act as a form of collateral, eventually debt, and the interest on that debt, has to be paid to the lender out of income. Thus, comparing total debt to total income is a gauge of how much capacity we have to service those debts without being financially stretched.

TODAY'S DELEVERAGING ECONOMIES FACE WHAT SEEMS TO BE A UNIQUELY DIFFICULT SITUATION: A WEAK GLOBAL ECONOMY, BANKING TROUBLES ACROSS MANY MAJOR ECONOMIES, AND LITTLE ROOM FOR FISCAL MANEUVERING.

At year-end 2011, the Total Debt of the U.S. economy stood at $54.1 Trillion as compared to a GDP of $15.3 Trillion. This works out to a ratio of 3.53 times[5]. This is down from 3.85 times in the first quarter of 2009, showing that some debt reduction is occurring.

It is also important to understand the break-down of these figures between private and public debt. As of year-end, total private economy debt was approximately $29 Trillion while gross federal and state debt (including debt of Fannie Mae and Freddie Mac) totaled roughly $25 Trillion. However, the trends are going in opposite directions since 2008: household debt has declined by 13% since 2009 at the same time that government debt has surged by more than 50%.

It is clear that some progress is being made to reduce debt, especially at the household level. However, if history is a guide, significant work still remains, with much of it being centered on the government portion of the economy. Importantly, McKinsey & Company has found that "US households have reduced their debt relative to disposable income by 15 percentage points, more than any other country; at this rate, they could reach sustainable debt levels in two years."[6] McKinsey goes on to predict that U.S. households are approximately half-way through this deleveraging process and debt to income for this portion of the economy could stabilize in two or three years.[3]

IN LOOKING AT THE ECONOMY TODAY, IT APPEARS CONSISTENT WITH PREVIOUS HISTORICAL EXAMPLES THAT DEBT TO GDP REACHED LEVELS THAT IT BECAME UNPRODUCTIVE TO THE OVERALL ECONOMY.

In our opinion, the evidence that the economy has been suffering from too much debt also comes through in the core economic data, which is likely the source of much of the uneasiness consumers feel today. As an example, standards of living have stagnated over the recent past. "Real median household income today is near the same level as it was fifteen years ago," write the investors at Hoisington Investment Management.[7] After three decades of growth that saw median household income (adjusted for inflation) rise by more than 6% each decade, the figure has declined by more than 5% since 1999. Many economists theorize that debt can lead to growing standards of living as long as it supports investment in productive growth and doesn't consume too much annual cash flow in the economy. When debt doesn't meet those criteria, though, it can hinder growth and result in a decline of household income.

The debt that was accumulated over the last few decades has shown mixed results in driving productive growth. The cycle over the last fifteen years saw significant investments first in technology and communications and then in housing and construction. Though large sums of money were lost in the late nineties' technology boom and bust, technological innovation spurred by the internet was a major benefit to the economy because it led to growth in worker productivity. However, the boom in residential construction provided only short-term GDP growth. The cycle of rising house prices allowed for additional consumer spending via cash-out refinances and house sales. However, the capital that was invested and subsequently lost in the housing bubble was not productive and has provided limited benefits in recent years.

In looking at the economy today, it appears consistent with previous historical examples that debt to GDP reached levels that it became unproductive to the overall economy. The economic data that we are witnessing today is likely a result of this pressure to reduce debt and create an environment where cash flows are once again available to invest in productive assets that can drive the next round of innovation and generate renewed increases in standard of living.

THE ROLE OF CENTRAL BANKS AND GOVERNMENTS

A final component needs to be interjected into the discussion about the post WWII cycle. Central banks have taken on a much larger role in the economy in recent decades and have been a major instrument in creating an environment where the debt Supercycle was allowed to take hold. Since 2000, the involvement of central banks and governments has taken on even more significance. In the years following the technology boom, fears of deflation caused the Federal Reserve (and other central banks around the world) to hold rates at extraordinarily low levels through 2004 which allowed the housing boom to gain momentum. In the years since the 2007/2008 debt crisis, all the major global central banks have been forced to maintain rates near zero, and the Federal Reserve has recently emphasized that they anticipate leaving them near that level through 2014. In addition to maintaining rates at very low levels, global central banks have also undertaken other 'extraordinary measures,' the most significant of these being quantitative easing. Though it has a complex sounding name, this is essentially when central banks create money to buy large amounts of debt in order to stimulate the economy. This stimulation comes from holding rates at extraordinarily low levels and motivates consumers and investors to spend and invest, when their inclination is to save and keep money in cash. Since 2008, the major central banks have expanded their collective balance sheets from approximately $3 trillion to more than $9 trillion via these actions.

Low interest rates are generally attractive, so it is reasonable to wonder what is wrong with keeping rates low. It is also difficult to understand how something as esoteric as the size of the Federal Reserve balance sheet has a direct impact on you as a consumer and investor. Though economists debate back and forth many detailed aspects of current policies, two potential risks are inflation and misallocation of capital. Inflation is widely understood after our experiences in the 1970's and 1980's. It is conceptually easy to understand - if the amount of money in the country grows faster than the overall economy, those dollars are going to be worth less. Because the Federal Reserve's balance sheet is essentially the foundation for the banking system, this newly created money can find its way into the economy through bank lending and if done rapidly would create inflation. Misallocation of capital is somewhat more complex, but basically occurs when investors and consumers make economic decisions based on incomplete or faulty information. Most specifically, if interest rates are held below natural levels, consumers may feel safe in taking on larger amounts of debt or investors may be encouraged to invest in investments that are too risky. Anyone that has had the urge to pull money out of the banks and invest it, "in anything that pays a positive cash flow" has confronted this risk.

At the same time that these monetary actions have occurred, the fiscal side of government has also been active in providing stimulus to the economy. Across most major developed economies, governments have maintained large deficits for five years, which has caused the outstanding amount of debt to rise dramatically. This follows historic precedent, as governments are forced to fill the gap from a declining private sector economy and they must step in to stabilize the banking sector. Budget deficits and the accumulated debt have now risen to levels not seen in our country's history, other than during war time.

LOOKING TO THE FUTURE

The last seventy years have seen tremendous growth and advancement in the size and diversity of the U.S. economy. By almost any measure we are more prosperous, innovative, and advanced than we were in 1950. That said, we are clearly at an inflection point and the trends that allowed for much of this advancement are no longer working. For several decades the Debt Supercycle helped increase our national wealth as high savings, investment, and innovation led to a rising standard of living. But at some point in the last decade, the cycle that was turning in a positive direction reached its limits and began to reverse. As such, the current downturn is different than those we have witnessed since World War II, significantly because of this process of debt reduction. However, the longer sweep of history tells us that this cycle will clear as well, and brighter days lie ahead. In future segments of this series we will discuss policy changes and economic strategies that we believe will lead to a renewed positive cycle.

AS ALWAYS, WE WILL REMAIN VIGILANT TO THE RISKS OF THIS REBALANCING, BUT HOPEFUL THAT IT IS CORRECTED WITHOUT ADDITIONAL MARKET CRISIS.

The recent financial crisis marked the moment that the private sector reached the conclusion that debts could not rise further. Since that point, the government has acted in material ways to cushion the blow from the reversal of the trends. For the most part, these policy actions have been successful and have thus far spared us from an outcome that would have likely been much worse than what we have experienced so far. That said, the process is not yet complete and the unprecedented actions taken have risks and unintended consequences attached to them.

We don't yet know when or how these remaining global imbalances will correct, but we would suggest that it is likely to happen over the next five years. As the private sector economy deleveraging is finalized the policymakers will begin to unwind some of the stimulus. We continue to believe that the eventual resolution of the debt deleveraging has widely disbursed and unknowable outcomes. As the analysts at Strategas like to say, "at some point the bill will come due." However, in our opinion, the critical question is whether the remaining imbalances are adjusted proactively or in reaction to market pressure. Just as in your life, taking action early when you have choices results in a smoother transition than waiting until a crisis forces change.

At SignatureFD, our thoughts on the market and the current environment drive many of our planning and investment strategies. For example, our portfolios are currently invested in an even larger number of investment ideas than normal. The goal being to include different types of investments that participate or protect from different environments. Some of these investments won't perform as well as others in some environments, but they are all included for specific possibilities.

Though uncertainty remains and the process of reducing debt will continue to be a headwind for economic growth in the next few years, we do believe the positive forces of human innovation and advancement will overwhelm these challenges. As always, we will remain vigilant to the risks of this rebalancing, but hopeful that it is corrected without additional market crisis. **The good news, no matter what...** we remain optimistic on the country, and believe that once the current cycle has fully run its course we will begin a new period of prosperity and growth. Human nature says this will probably begin to happen when most believe it never can. Judging by the growing debate about the permanent decline of our way of life, this point seems to get closer every day.

SOURCES

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