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What We Think.......

***There are no shortcuts to anyplace worth going!* (Beverly Sills)**

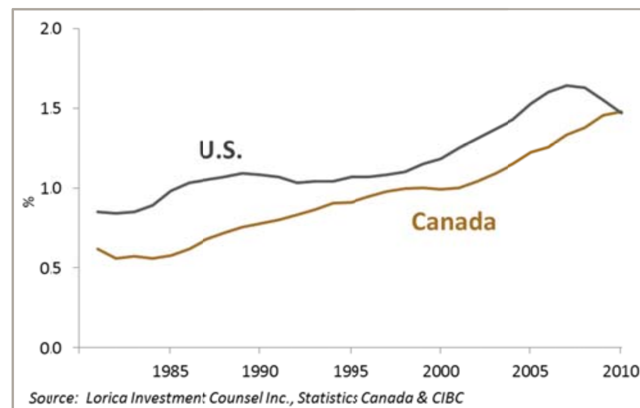
In 2008 when central banks and politicians around the world acted in concert to avert falling into the economic and financial abyss (many felt Lehman's collapse was the first glimpse), it was difficult to argue with policymaker's decisions. We didn't have the benefit of experience and hindsight (although today one has to question whether that has changed) and we certainly did not have the benefit of time. Initially, it was reasonably clear to me that the objectives of the policy initiatives were focussed – to avoid capital market and inevitable economic collapse at all costs. However, longer term goals were gradually overlaid on top, albeit with less political consensus but with equal urgency. Recall President Obama's now departed chief of staff, Rahm Emanuel's quote in a speech to the Wall Street's Journal CEO Council on November 20, 2008: "You never want a serious crisis to go to waste." In the U.S., the epicentre of the crisis, it did not take much convincing of the ordinary citizen that a dramatic response was necessary; while at the same time the government capitalized on the crisis to implement other agenda items, such as health care and financial services reforms.

It has been almost three years since the debt crisis, yet we are still left plagued by the questions of what is appropriate policy response from central banks and governments (and we will throw in the IMF for good measure). While the epicentre of the debt crisis has sailed across the Atlantic, the same questions of nature and extent of policies are being asked. It is interesting that with the benefit of hindsight, one would have expected policy-makers to have mitigated some of the time pressure surrounding policy decisions. However without the sense of urgency, something we are now seeing in Greece, it is not always realistic to see any kind of policy agreement. Take the U.S. debt ceiling negotiations as an example, with a definite ultimatum still some time off, republicans and democrats seem content with posturing and showmanship.

The Debt Super Cycle

The Bank Credit Analyst publicised the concept of the Debt Super Cycle (DSC) to describe the long accumulation of debt in the developed world. Figure 1 shows the increase in U.S. and Canadian consumer debt burdens over the last thirty years. In simple terms, the collapse in 2008 was precipitated by the DSC, as excessive leverage on the part of consumers and financial institutions in the United States resulted in financial markets precariously exposed to poor credit. Following the Lehman collapse and the ensuing credit crisis, we were left with a U.S. economy with a significantly impaired ability to assume more private sector debt – as banks tightened lending standards and consumers retreated from borrowing. The U.S. entered the next phase of the DSC via the government's fiscal response to the crisis as massive stimulus spending together with the expansion of automatic stabilizers such as unemployment benefits effectively shifted debt to the public sector.

Figure 1. Household Debt to Personal Disposable Income



Source: Lorica Investment Counsel Inc., Statistics Canada & CIBC

While the recent focus has been on raging government debt burdens in the U.S. and Europe, it is noteworthy that Japan's debt burden has been mounting for some time without anyone paying

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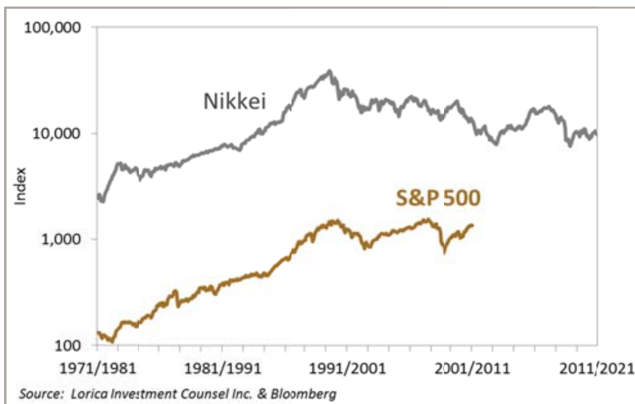
much attention outside of Japan. (It seems that Japan's economy has only becomes a hot topic recently with the questions about the earthquake and tsunami's impact on the global supply chain.) However, the fact remains that Japan has enacted years of stimulus fiscal policy in successive attempts to kick-start its moribund economy while the rest of the world was growing at a decent clip.

Figure 2. S&P 500 & Nikkei Logarithmic & Nikkei Lagged 10-Years



The saving grace for Japan has been the good grace of its savers who have been content to finance Japan's deficits through their purchases of JGB's (at punishingly low rates), a situation that no other highly indebted country can rely on. Despite no immediate concern over Japan's debt situation, the reality is that Japan reached the last phase of the DSC ahead of other developed countries. Significantly, any change in Japan's ability to self-finance, such as from a fall in savings due to higher unemployment, would likely land Japan's fiscal situation somewhere between the U.S. and the highly indebted Eurozone countries.

By our account Greece should have reached the end of the DSC – a situation when the lender of last resort is bankrupt. Well, at least that's how it is supposed to be, but because Greece is part of the Eurozone and its future is thought to be critical to the ECB, and its debt burden is nowhere near as large as that of Spain but rather a rounding error for Germany, Greece's time in the Debt Super Cycle has been extended for now. However, what Greece's predicament has presented is a particularly difficult path for European policymakers, who are clearly not having a good time with it. There is now no obvious knee-jerk response to the Greek debt situation – that was not true last year when extending loans to Greece seemed like the obvious response to buy more time. However, a year later with organic reform to the Greek economy evidently only a pipe-dream, officials have been seemingly unable to arrive at the right policy response.

The developed world is awash in government debt, and moving it from one sovereign to another will not be the solution – there is neither appetite nor capacity for this. In Greece's case the proverbial *can* will be *kicked down the road* for at least another quarter, but European policymakers will inevitably be confronted with the question of how to reduce debt burdens when the solution of greater economic growth is not a realistic one. When a severely indebted sovereign nation cannot turn to its population through borrowing or taxation, and there is no other lender of last resort, some sort of default is inevitable. In the case of Greece, we feel it is only a matter of time.

QE3 is not QED[1]

TARP, auto bailouts and bank loans were reflex responses to the U.S. debt crisis of 2008. So was QE1 and so, some would argue, was QE2 – a double dip recession last year may have precipitated a broader market collapse. With the crisis in '08 ebbing further into the past, it will be

[1] My university math professors used to end elegant math proofs with the words QED – *quod erat demonstratum* meaning *that which was to be demonstrated*, signifying that the proof was arrived at by an unbroken chain of logic; we used to urbanise it as "quite easily done". Either way the logic behind QE3 will be far more difficult to demonstrate than for either QE1 or QE2.

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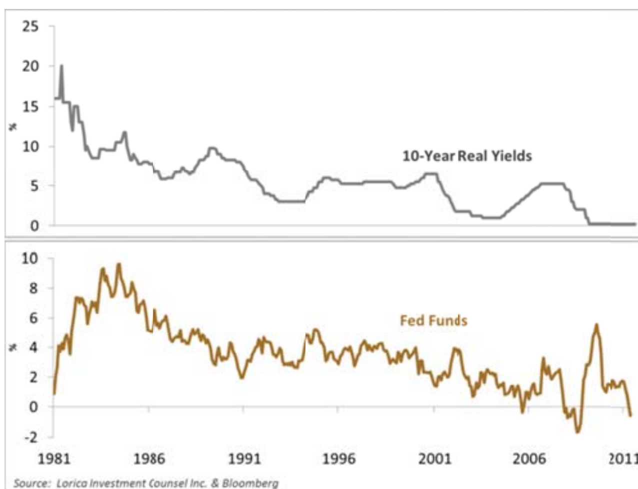
difficult to prove that QE3 would be anything other than a monetary policy response to an unacceptably slow economy. Unfortunately, where economic growth is concerned, there are no shortcuts. On one hand, the United States, like a host of other developed countries, is approaching the point when it can no longer borrow and spend way beyond its means – a debt to gdp ratio expected to be 69% by the end of this year, with over 50% of marketable treasuries in the hands of foreigners, and a very politicized budget debate will ensure this. On the other hand, the U.S. is left with little room for further monetary policy support – something that I would argue it has become accustomed to over the last twenty years.

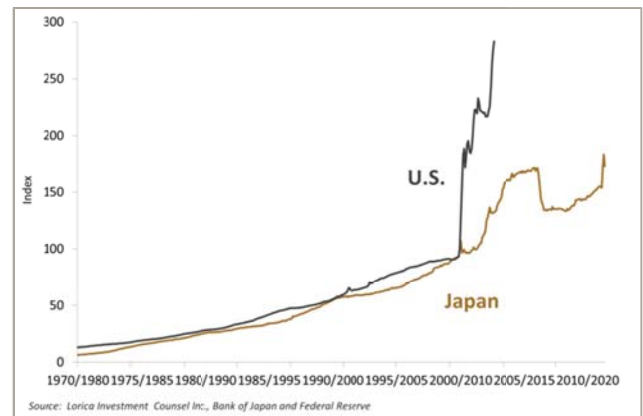
Look at the top graph on Figure 3, which shows the decline in U.S. 10-year real yields from the 1980's – the trend is unmistakable. The bottom graph shows the Fed Funds rate over the same period. The combination of low short term interest rates and declining real yields fuelled a boom in private sector debt in the U.S. which propelled the U.S.'s domestic led economy through the 1990's and much of the 2000's. The trend is similar in other developed countries.

Figure 3. U.S. 10-Year Real Yields and Fed Funds



Before the start of Japan's lost decade, it too had declining real yields and interest rates. As Japanese rates bottomed, there were years of policy response from both the Bank of Japan and the Ministry of Finance without much success. Unfortunately, there are no policy shortcuts to real progressive economic change in today's globalized economies. Like much of the western world, Japan has seen some of its important industrial base migrate to other parts of Asia, without sufficient economic adjustment – a situation that fiscal and monetary policies appear to have been unable to counteract.

Figure 4. U.S. & Japanese Monetary Bases Indexed to 100: U.S. September 2008, Japan December 1999 (local currency, Japan lagged 10 years)



In our view, the U.S. economy is in a similar place to where Japan was roughly ten years ago, but without the benefit of being self-financed; but with the benefit of: having observed Japan's experience, a more aggressive populace, and most importantly reserve currency status for the U.S. dollar. Figure 4 shows the different policy responses between Japan and the U.S.'s experiences with near zero interest rates. Although, both central banks intervened in response to deflation fears, the growth in the U.S. monetary base was much quicker and stronger than that of the Japanese.

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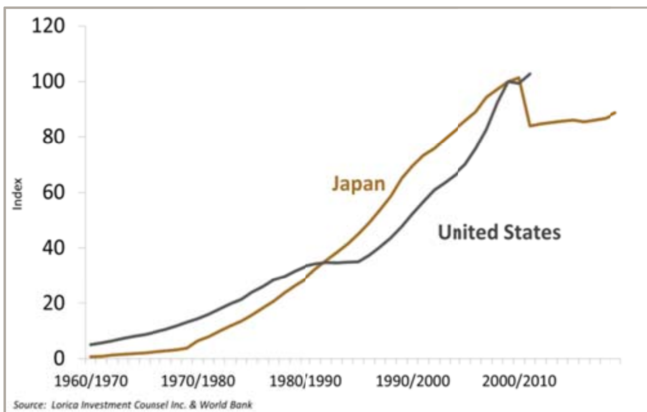
It remains to be seen whether the change to money supply – Figure 5, will be substantially different between the two countries – we are sceptical. Like the Japanese experience, we are doubtful as to whether there will be any policy shortcuts to overcome the similar need for real economic restructuring.

Figure 5. U.S. & Japanese Money Supply Index to 1100: U.S. – 2008, Japan - 1999



Slow Growth and Risk-On/Risk-Off

Just because we don't think there are any short-cuts to growth, it doesn't mean we don't think policymakers won't try to find some. We expect monetary and fiscal policies aimed at promoting higher growth to continue, but without the political advantage of being viewed as crisis responses. In the case of the U.S., the handcuffs around stimulus policies are getting tighter leaving less room for big response and even the danger of over-exuberance on constraint. Although we do foresee slow growth, we feel that without a *policy mistake* a recession will likely be avoided.

The situation in Europe is slightly more confusing with the PIGS continuing to require support while at the same time Germany's hyper-driven manufacturing based economy is in need of tighter monetary policy. We think the demands of the weaker countries will supersede those of Germany over the near term.

The Canadian and U.S. economies have been less in sync over the last several years, , but we feel that may be somewhat less true in 2011 and 2012. Canada had lagged other developed countries on the Debt Super Cycle as Canadians took on far less debt leading up to 2008. However, as Figure 1 shows, as consumer debt burdens have fallen in the U.S. (and elsewhere) post 2008, they have risen in Canada, as Canadians responded to low interest rates and healthy balance sheets by taking on more debt and growing the Canadian economy. With fiscal policy set to tighten in Canada and mortgage reform already in place, one should not count on the consumer for the same kind of participation going forward.

Growth in emerging economies will likely continue relatively unaffected by the problems facing the developed world. However, inflation will likely continue to be a problem in these economies, and therefore one should expect countercyclical monetary and fiscal policies also to continue. While this will not necessarily help demand for U.S. and European exports, it will alleviate some of the pressure on commodity prices that have routinely hurt U.S. and European consumers.

The risk-on/risk-off trade which has been driven by policy intervention and the implied insurance for risky assets has been a favoured game during the last two years. Every-time risky assets have been in any kind of danger; policies have been invoked to encourage investors to take risk – in a fashion reminiscent of the period leading up to the credit crisis. However, with supportive policy more constrained, risky assets will not likely get the kind of kick that QE2 and last year's Greek loans provided. Perhaps the difference this time is that investors are more aware of the downside, and hence seem a lot quicker at applying the brakes.

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