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MACROCOSM

# Is This a "New Era" Recession?

Monday, December 29, 2008

**Donald Luskin**

**We don't see the case for a secular collapse in consumption.**

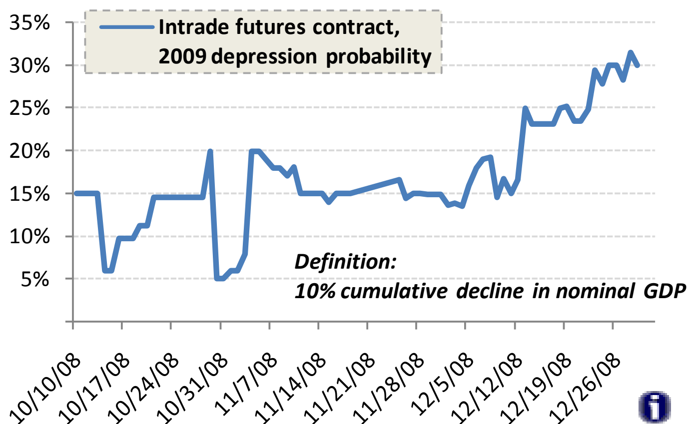
Most of our conversations with clients now are dominated by the question: *when will this recession end?* Answering that question will be the focal point of our research going into the new year. Today, we'll address the overarching matter of the developing consensus that this recession is *different* -- and likely to be worse -- than any other experienced during our lifetimes. Many clients are concerned that it will be quite deep and prolonged, more of a depression than a recession, reflecting profound, painful and potentially permanent structural changes in debt and consumption. In a nutshell, *it's a new era*.

**Update to strategic view**

**US MACRO:** We don't see a "new era" of deep and prolonged retrenchment of an overindebted household sector. For us the critical factor in coming out of recession is the preservation of the global banking infrastructure that will support the lending necessary for income and wealth creation, and consumption will take care of itself.

[see Investment Strategy Dashboard]

We agree that this recession is unique. For starters, it's the first post-war downturn *not* to have been triggered by extremely high real interest rates imposed by the Federal Reserve. And we know of no parallel to the dysfunction of world credit markets that was catalyzed by the US government's unpredictable and equity-punishing interventions in distressed financial firms in the late summer, which abruptly turned what had been only a slowdown into this recession (see "Death by Rescue" November 17, 2008). But *every* recession is in *some* sense unique -- and while the best forecasts will arise from understanding the unique elements, bad forecasts will arise from failing to acknowledge the many elements that are in common with other recessions. As ever, it will be very expensive to say too casually "this time it's different." And saying "it's a new era" will be the worst of all -- it always is.




We don't need to remind you of the many times in the history of markets investors have come to believe in a "new era," and

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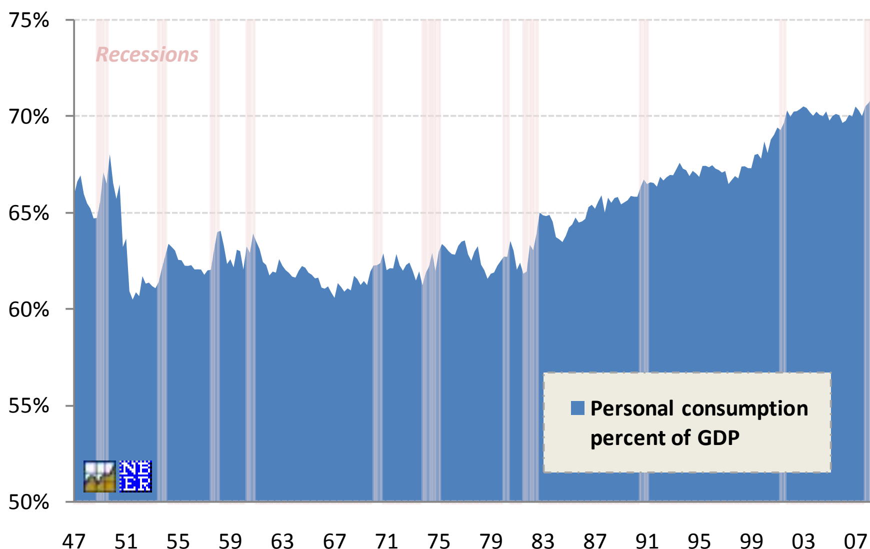
the pain that has inevitably followed. In just the last decade we've seen several examples -- the "new era" of Internet companies, the "new era" of securitization, the "new era" of home-ownership, and the "new era" of expensive energy. So it is today, with respect to the "new era" of falling consumer demand. One analyst said last week the economy is entering a "new era" of "scrimp and save." That analyst was none other than Henry Blodget, one of the most notorious proponents of the "new era" in Internet stocks in the late 1990s. He said it without a trace of irony on his website, by way of introducing an interview with Gary Shilling, an economist who has been so extremely bearish for so many years -- literally decades -- it ought to be impossible to take him seriously. Yet at the moment he looks right, so he gets attention when he predicts a return to "the enforced frugality of the 1930s and 1940s." Merrill Lynch's David Rosenberg, an economist of greater credibility who is also harvesting a correct recession call, takes essentially the same position as Shilling. In a report for clients two weeks ago he introduced a "new theme" that he calls "frugal future," in which there will be "epic changes" in spending and debt. It's a collapse of aggregate demand, the retrenchment of the over-indebted consumer.

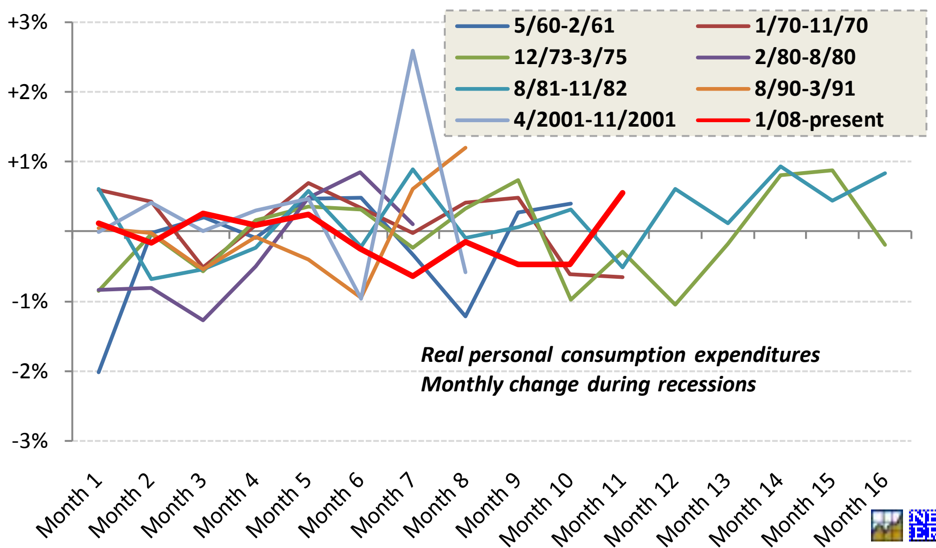
We tip our hats to anyone who called it right this year, for whatever reason. And we don't dismiss anyone's forecasts now simply because their "new era" language may make them sound similar to over-reaching predictions in the past. We *do* take them as contrary sentiment indicators, but that doesn't mean they are objectively wrong. In an important sense, Blodget and the other superstar technology analysts of the late 1990s were *right* -- the Internet really did usher in a "new era" of communications and commerce, and many technology companies have experienced enormous earnings growth since then. But the sentiment environment then was so euphoric, securities prices had more than discounted the best possible outcome, and in almost all cases investors who bet on the "new era" -- which did in fact arrive -- nevertheless experienced major losses.

We can't know for sure that securities are as fully mispriced today as they were at the top in 2000, or that pessimism is as over-the-top today as optimism was then. But if they're not, surely they are close, with stocks having already dropped far enough to nearly match the second worst bear market in history, with the equity risk premium at levels not seen since 1953 (see "At Least They're Cheap" November 20, 2008), and with credit spreads at levels not seen *ever* (see "It's a Recession -- Not the End of the World" November 21, 2008). From here, even if a "new era" of consumer retrenchment *does* eventually materialize, there's no reason to think that securities have to get all that much cheaper -- and in the short-run, sentiment is extreme enough to power a considerable rally. And if the bleak "new era" being forecasted now *doesn't* materialize -- if this turns out to be just another recession -- then the opportunity on the upside is nothing short of stellar.




Will the bleak "new era" materialize, or won't it? Let's begin by understanding what the "new era" advocates are saying. The consistent centerpiece of virtually all the "new era" arguments is the fact that personal consumption has risen to record levels as a fraction of gross domestic product, as shown in the chart at left. The "new era" case,

basically, is that for a variety of reasons, the record consumption share of GDP is now destined to sharply contract, with dire consequences for growth.




So far in this recession, growth of real personal consumption expenditures has been weak, but as the chart at left shows, not especially different from past recessions. Despite this weakness, from recession onset one year ago through the end of the third quarter, the consumption share of GDP has actually *risen* -- just as it has risen in every post-war recession but one. But let's look to the future, in which a two-part test of the "new era" case would be to determine (1) whether or not there are good reasons to expect the consumption share of GDP to substantially contract, and (2) if it does so, whether or not that is a bad thing.

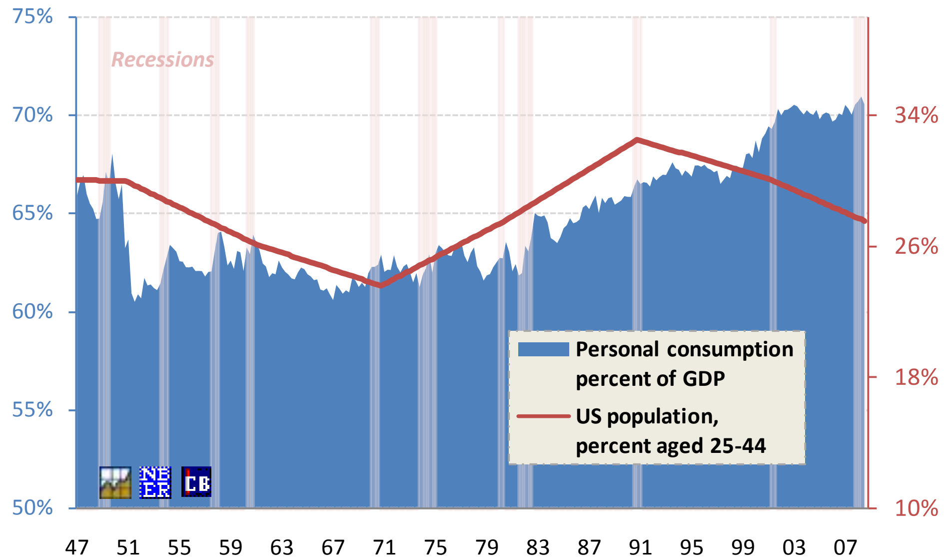
**LOOKING AT THE ARGUMENTS** There are many different arguments given to support the "new era" case for contracting consumption. The most interesting is the idea that the economy will have to downshift to a permanently lower level of debt. We'll discuss that in detail, after quickly looking at some of the other reasons.

**THE STATISTICAL ARGUMENT** Many "new era" discussions treat it as nearly self-evident that the consumption share of GDP must contract, simply because it is at an all-time record -- it is "out of pattern," and must "return to normal." But just looking at the data, it doesn't seem self-evident to us at all. In the chart on the previous page, one sees no obvious cyclical or mean-reverting tendency in the consumption share. After a sharp drop from its high levels in the immediate aftermath of World War II, it stayed in a range between 60% and 64% from the early 1950s to the early 1980s. It broke from that range and rose fairly consistently during the 1980s and the 1990s, and reached approximately today's level of about 71% in 2001. The consumption share has been at about that level for seven years now, and during that period has exhibited more stability than during any other period in the data.

**THE DEMOGRAPHIC ARGUMENT** Some "new era" discussions cite the maturation of the baby-boom generation as the reason for the rise of the consumption share of GDP, and as an explanation for the relatively mild business cycle fluctuations of the last two decades. Now, they argue, with the boomers' impending aging and retirement, the consumption share must fall and recessions will become deeper and longer lasting. As David Rosenberg put it in a report two weeks ago, boomers cushioned the last two recessions when their median age was in the 30s and 40s, "young enough to be trading up." But this time it's different. Rosenberg writes,

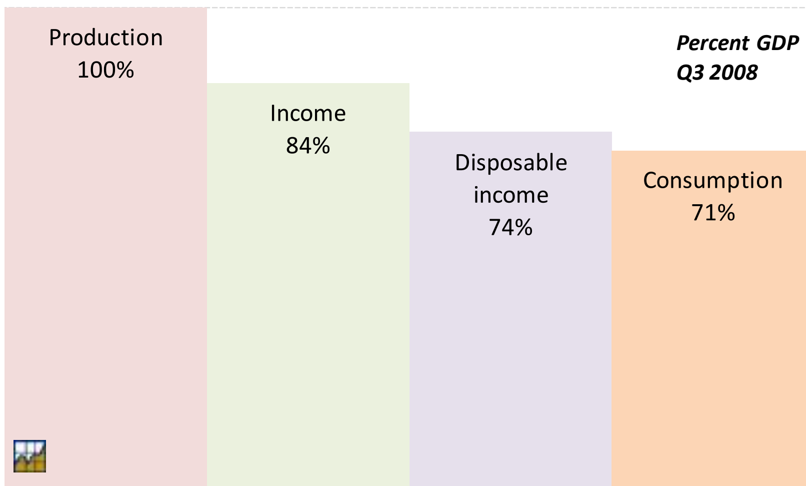
> The median boomer is moving into his 50s. After a buying boom over the past 20 years…it looks as though the boomers are done. For the first time in four decades, we

cannot expect to see the demographic cushion to consumer spending that helped ease the blow in each of the recessions dating back to the 1970s.



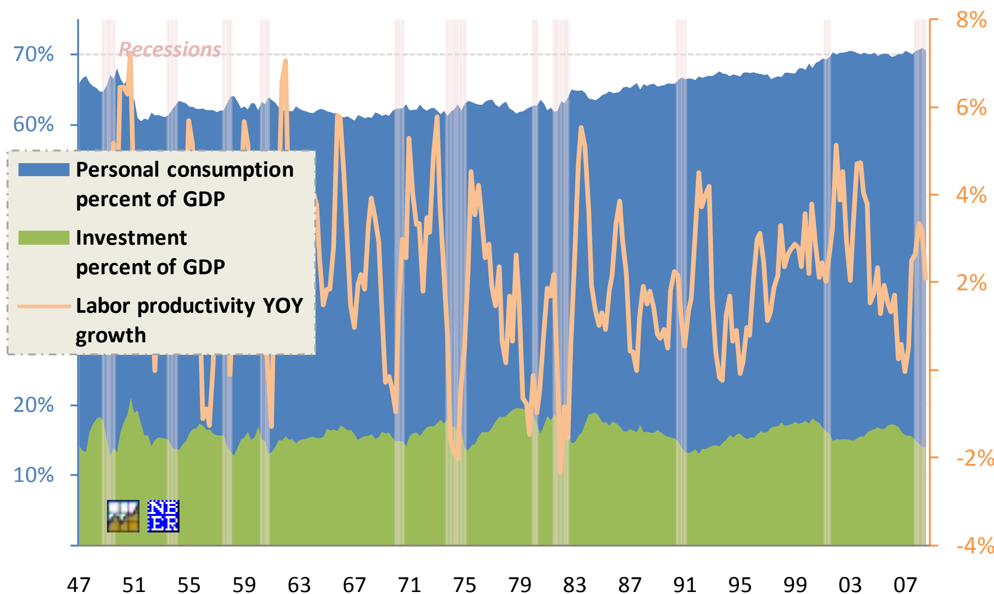

Even if resiliency of consumption is indeed a function of a population "young enough to be trading up," tracking the median age of the boomers isn't a sensible way to grasp the phenomenon. The focus ought to be the *percentage of the population* that is "young enough to be trading up." In the chart at right, we see the percentage of the US population aged 25 to 44, mapped against the consumption share of GDP. The population percentage "young enough to be trading up" peaked in 1990, and has been falling ever since -- at the same time as the consumption share has risen to its present record high. So we would have to conclude that this demographic element is not relevant. If demographics are involved at all, more likely to be relevant is the steadily rising percentage of the population aged 65 and above, a group that is likely to consume more -- a population trend that has tracked the steady rise in the consumption share of GDP, and is almost certain to continue for the foreseeable future.

**THE IMBALANCE ARGUMENT** To some observers, the present 71% consumption share of GDP is unsustainable -- it is asserted that a healthy economy simply cannot function with consumption taking up such a large share of production. According to Edward Leamer, the UCLA econometrician whose research this year has contributed fundamentally to the identification and dating of business cycles, we could be "in the early stages of a major structural adjustment" -- that is, a "new era" -- because "We are not an ownership society, we are a consumption society." In this way the "new era" case links up with observations made many times over the last several years that the United States has become, as Warren Buffett put it in 2003, "Squanderville." According to Buffett we "consume…more than we produce."




It is simply not true that we consume more than we produce. As seen in the chart at left, out of our total production, 84% is earned as gross personal income. 74% remains after taxes, as disposable personal income. 71% is spent in consumption. In theory, there is nothing that would prevent an

economy from channeling 100% of its production into consumption, at least if we assume away the cost of government (but most of that ends up in consumption, too).



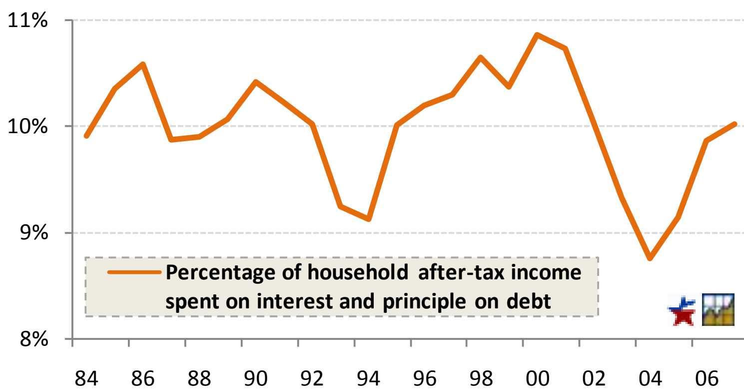

What about consumption crowding out investment? As the chart at left shows, that appears not to have happened in the US economy over the last decade, in which the investment share of GDP has been pretty much the same for 60 years, even as the consumption share has steadily grown. Investment has fallen a bit in the last decade, but much less than the consumption share has grown -- and note that most of that fall has been in the last two years, as residential investment has slowed sharply.

The rise in the consumption share does not appear to have had a negative impact on labor productivity growth. In fact, in the 1990s, when the consumption share of GDP accelerated most dramatically, productivity growth accelerated as well (prompting many at the time to proclaim a "new era"). One explanation for this coincidence is that, as pathbreaking research by the McKinsey Global Institute has shown, a dominant fraction of the late-1990s productivity surge came in the retailing and wholesaling sectors, from efficiencies achieved by Wal-Mart and competitors learning from Wal-Mart. The coincident rise and subsequent high plateau in the consumption share of GDP could be a rational response to the increased cost-effectiveness of consumer goods and their delivery to consumers, or to the lessening of certain kinds of risk in a globalized, just-in-time Wal-Martized world.

**THE DEBT ARGUMENT** In fairness to Leamer and Buffett, their arguments go beyond a critique of the rising US consumption share *per se*, and integrally involve the sharp increase in the indebtedness of the US economy.

When David Rosenberg states "consumers have entered into a major spending downturn… This is a secular trend," he links it to the exhaustion of consumers' ability and willingness to borrow. He says, "The situation is so dire…households are…spending a near-record 14% of their after tax income on interest and principle…this is more than we are spending on food. …The buy now/pay later days are clearly behind us."

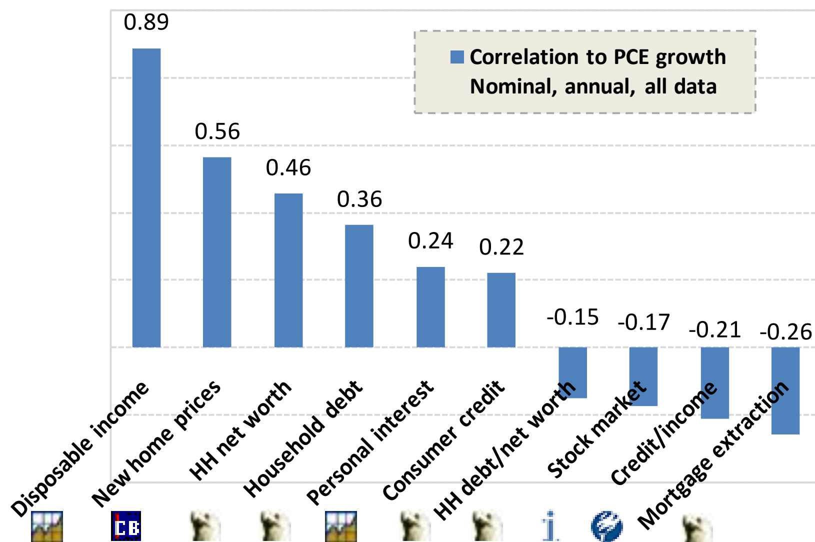
The issue of consumer indebtedness deserves serious exploration, but at the outset it's more than mere nit-picking to point out that the "dire" statistics Rosenberg cites are wrong in every respect. It says something about the present state of pessimism that one tends to accept such things without questioning them. The fact is, according to the Consumer Expenditure Survey of the Bureau of Labor Statistics, and the National Economics Accounts of the Bureau of Economic Analysis, the average household spends only 10% of after-tax income on interest and



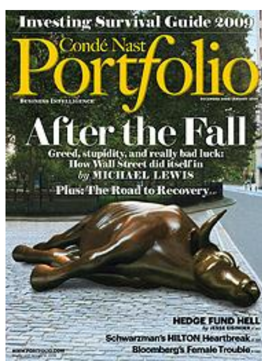

principle on indebtedness, not 14% as Rosenberg claims. As the chart at left shows, that's *not* a "near-record" -- it's about average for the period since 1984, during which the percentage has fluctuated in a narrow range. And for the record, it's a little *less* than the percentage spent on food, not more.

More fundamentally, we think the Rosenberg and most other "new era" advocates err in assuming a strong *causal connection* between indebtedness and consumption. Yes, the rise in the consumption share of GDP has occurred simultaneously with a rise in gross household indebtedness. But that's not to say we know for sure that the indebtedness *caused* the consumption -- yet most "new era" analyses critically depend on this connection, and treat it as axiomatic. For us, the true axiom is that *for one man to go into debt in order to consume, another man has to forego consumption in order to lend*. So in the aggregate it is fundamentally impossible for increased debt to lead to increased consumption. The only way to consume more is to earn more, or have more wealth.

Statistical evidence bears out our analysis. As the chart at right shows, growth in personal consumption expenditures is highly correlated to growth in *disposable personal income* -- a correlation of 0.89, or an R-squared of 0.79. Consumption is also somewhat correlated to changes in wealth as measured by new home prices and net worth, with correlations of 0.56 and 0.46, or R-squared's of 0.32 and 0.21, respectively. However, changes in household debt, personal interest payments and consumer credit are much less correlated. The most highly correlated of these, household debt, has a correlation to consumption of only 0.36, or an R-squared of 0.13 -- which is to say that its variance explains only 13% of the variance in consumption, while that of disposable income explains 79%.This tells us that if we want to understand what is likely to happen to consumption, we'd be better off focusing first on income, and next on wealth, rather than debt.



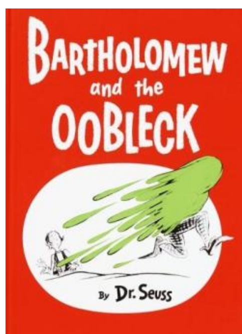

**HOW DEBT MATTERS** So for us, our main interest in debt is to understand how it affects income and wealth. Our starting point is that debt is a *technology*, and it affects income and wealth as does any technology -- such as, say, the Internet -- by improving productivity. Debt does so by channeling financial resources *from* people with a wealth-surplus and an idea-shortage, *to* people with an idea-surplus and a wealth-shortage. It is a classic example of specialization, comparative advantage and gains from trade. As with any technology, wealth and income are maximized when the technology of debt is plentiful, and when it is used wisely.




But in the last five years of falling global interest rates and declining lending standards, it would appear that too much wealth was chasing too few good ideas. Ben Bernanke, in a [2005 speech](), called it the "global saving glut." The price of the technology of debt -- expressed as low interest rates and lax lending standards -- was driven too low, and so debt was overused. The result was, to cite Rosenberg's list, "no-doc loans, lowdoc loans, liar loans, NINJA loans (ie, no income, no jobs, no assets), 0% vendor financing, subprime mortgages, Alt-A, and option ARMS with the negative amortization feature." And banks [stupid enough]() to do it all with 40-to-1 leverage. The cessation of this overuse -- indeed, this abuse -- of the technology of debt is itself no threat to future economic growth.

At least not in principle, but in reality the way it occurred has been a severe shock. We lost some key financial firms, and to a large extent that was inevitable in light of the lending and leverage mistakes they made. But the impact was exacerbated considerably by counterproductive *ad hoc* government interventions that served only to worsen the systemic risk they were intended to ameliorate (again, see ["Death by Rescue"]()). So on top of what would already have been a severe blow to the operation of the global banking infrastructure and investors confidence in it, investors have learned they also have to worry about the unpredictable and potentially destructive behavior of governments.

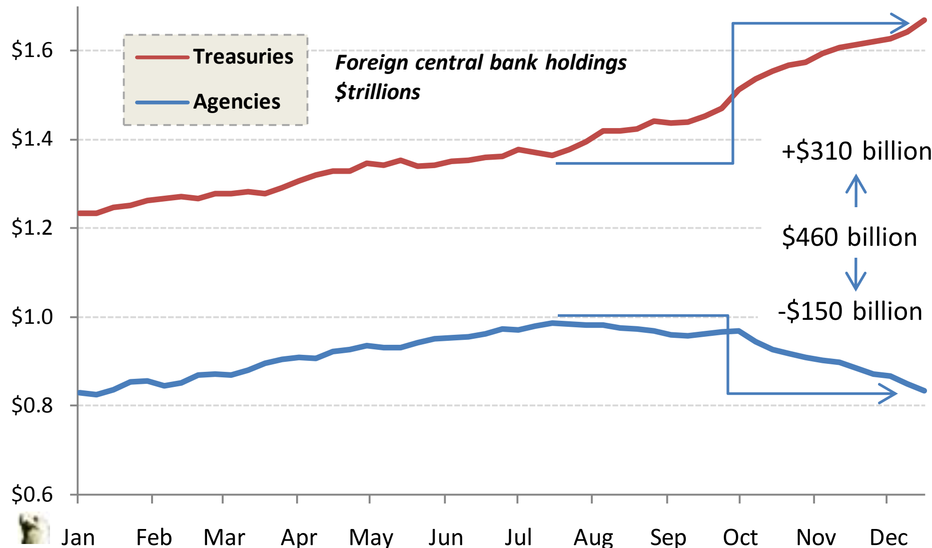
Since mid-October, we see the same government authorities that did so much to exacerbate the dysfunction of the global banking system in the late summer now engaged in a sustained and credible effort to do even more to repair it (see ["At Last: A Bail-out That's a Bail-out"]() October 14, 2008; ["Another Rescue, A New Rescue Ranger"]() November 24, 2008; and ["'Some Time' A Great Notion"]() December 17, 2008). The continued constructive participation by government in healing the banking system -- preserving the infrastructure for delivering the technology of debt -- is the *sine qua non* of recovery from this recession, and the bulwark against this becoming a bleak "new era."




We can say that because, absent these critical institutional considerations that affect how credit is intermediated, borrowing and lending itself *can't not take* place -- it is an inevitable characteristic of wealth itself. This stands in opposition to the often-heard notion that we are going through a period of "deleveraging," after which the total amount of debt in the world will be reduced. But debt cannot actually be reduced -- like the substance "oobleck" in the [Dr. Seuss book](), it can only be moved from place to place, and change forms. Even cash itself, seemingly the most unleveraged financial asset of all, is debt -- money, by its very nature, is the non-interest-bearing debt of government. So the only way that debt can be extinguished, ultimately, is for money to be extinguished, and only central banks can do that. A prime cause of the Great Depression was that the Federal Reserve did just that -- it extinguished [28% of the money stock]() from 1929 to 1932, triggering a multi-year monetary deflation, crushing asset values, and making debtors unable to meet their obligations. The Fed today is doing nothing of the sort -- it is doing the exact opposite, with the monetary base now growing at a 1200% annual rate over the last three months.

So if we had a "global saving glut" before, we certainly still have one now. And since there is no escaping the axiom that for one man to save, another man has to borrow from him, one way or another there will be a high level of global debt. The question is what we do with it, and how we intermediate it. If there was too much wealth chasing too few good ideas before, that's even

more the case now -- amplified by the fact that surplus wealth is, for the moment, only interested in the least risky investments.




After the tribulations of the last year, saving is being channeled to the most riskless borrowers -- sovereign governments. While the global banking system is impaired, those governments will have to act as risk-bearing intermediaries between lenders and less-than-riskless borrowers. For instance, since July foreign central bank holdings of US Treasury securities has grown by $310 billion, as shown in the chart at left. But at the same time, holdings of agency securities have fallen by $150 billion. That's a net increase in lending of $151 billion, but a $460 billion swing toward riskless Treasuries and away from relatively risky agencies. Last month the Fed stepped in as the risk-taker of last resort -- it announced it would buy $500 billion of agency securities. So lending marches on, but until markets build the confidence required to make less-than-riskless credit decisions, for the moment the intermediation process has had to adapt to circumstances.

A crutch, to be sure. But while the infrastructure for delivering the technology of debt is in rehabilitation, a crutch is just what we need. Full robust recovery will come when the banking system can walk unassisted. We're beginning to see small tentative steps in the narrowing of some credit spreads over the last several weeks. But in the meantime, that crutch is the difference between a long recession and a bleak "new era." It's bad news that we need it. It's good news that we have it.

**BOTTOM LINE:** We don't see a "new era" of deep and prolonged retrenchment of an overindebted household sector. For us the critical factor in coming out of recession is the preservation of the global banking infrastructure that will support the lending necessary for income and wealth creation, and consumption will take care of itself.