

January 2011

# Outlook on the **United States**

The year behind us was one in which significant elements of uncertainty were largely resolved. As we look to 2011, we believe that the U.S. economy is poised to perform well.

That said, aggregate indicators tell only part of the story. We expect to see differentiation across various strata of the economy and in terms of company profitability. The elements of uncertainty that remain are generally outgrowths of policy decisions made in 2010—as unorthodox remedies can sometimes have unexpected side effects.

Beyond 2011, the secular themes of deleveraging and reregulation remain firmly entrenched. Previously, we had discussed an overriding sense of uncertainty and the increasing importance of government decision-making as a potential third theme. Now, we are seeing widening divergences based on education, age and employment sectors and increasing potential for this divide to impact policy decisions regarding taxation, social services and trade policy.

Against this backdrop, U.S. equity markets began a strong rally in late August, around the time when Fed Chairman Ben Bernanke spoke about a second round of quantitative easing (QE2) in Jackson Hole, Wyoming. While shares are up materially, we see room for continued gains in many areas of the market as the companies with the strongest balance sheets and cash flow take advantage of the resulting operational flexibility to grow their profits at a pace in excess of that of their peers.

## Headlines From the Year Behind Us

### 1. A year of answered questions

Even though many companies became more profitable in 2010, equity valuations did not respond until late in the year. One possible explanation for the delayed recognition was a background of heightened macroeconomic, political and regulatory uncertainty that made investor behavior appear binary—between being eager to take risks and avoiding risk altogether.

Investors legitimately lamented the risk-on/risk-off nature of equity markets, and what appeared to be a lack of discrimination between companies that were delivering operational improvement and those delivering financially engineered improvement. Companies in the latter group appeared largely to be beneficiaries of a dichotomy across asset classes in which fixed income investors were full-throttle risk-on through most of the year. In particular, with high-yield debt issuance at record highs in 2010, companies we had expected to struggle not only persevered but refinanced at even lower borrowing rates.

By the end of the year, however, fixed-income investors had reached a point of asymmetric risk/reward that made them reconsider committing more capital to debt. Even the leaders of major fixed income firms began to observe that equities were more attractive than debt.

At the same time, investors began to realize that many elements of uncertainty that had previously dampened enthusiasm for equities were being addressed. These included, but are not limited to:

- Whether the Federal Reserve would engage in QE2 and if so, to what degree.
- Where tax rates would be beyond 2010.
- Which party would control Congress after the November elections.
- What shape healthcare reform would take.
- How new financial regulations in the U.S. and capital requirements from Basel III might affect the financial sector.
- What the ramifications of the BP/Macondo oil disaster would be.

While not all of these questions have been answered completely, we do know now that QE2 is underway (and that quite a few leaders outside of the U.S. are not enamored of the program). We know the tax rates for 2011 and 2012. We know that the GOP now controls the House of Representatives—and we have an early sense that perhaps, when push comes to shove, the two parties can collaborate to some degree. While we still do not have complete transparency on the new healthcare rules, financial regulations or energy exploration and production rules, we do know that, with the new makeup of Congress, change is likely to be less disruptive than it might otherwise have been.

Most importantly, at this point, investors appear to be much more confident in their ability to forecast profitability by industry and company and to discriminate accordingly in committing capital.

## 2. Contagion from the private to the public sector

While financial institutions, consumers and companies in many developed markets continued to deleverage their balance sheets through 2010, their efforts were largely, if not completely, offset by increases in public-sector debt. Essentially, governments across the developed world socialized private-sector debt through massive fiscal deficits resulting from tax cuts, incremental spending or some combination of the two.

On three separate occasions last year, the risk of socializing debt was highlighted in the form of European sovereign flare-ups. In late January/early February, Greece's crisis hit the headlines for the first time. The situation was calm thereafter until May, when the acronym PIIGS (Portugal, Ireland, Italy, Greece, Spain) entered the vocabulary of many investors. As we moved into the second half of the year, Ireland provided evidence that segmenting debt by sector, while interesting, is not always relevant. While the country entered the period in a relatively strong fiscal position, its banking sector was staggering under a debt load in excess of 500% of GDP. Unfortunately for the Irish taxpayer, the government had announced a blanket guarantee of deposits and bank borrowings late in 2008, making the banking sector's debt an unsupportable government liability. Worse still, the more investors realized that the Irish government could not support its debt, the less credible its banks and the government became in the debt markets.

While we are in another hiatus in terms of European sovereign credit, we believe this story has not been completely played out. In fact, we believe it will get worse before it gets better.

## 3. Continuing stress in real estate, and pain for state and local governments

Though we saw signs of stabilization and even recovery in housing prices early in 2010, the good news faded as the year wound down. In fact, as we exited 2010, residential real estate prices had resumed their steep decline.

Commercial real estate prices also appeared to be stabilizing mid-year, but our hopes have dissipated here as well. We saw investors forced into the commercial real estate market in search of yield when the 10-year Treasury yield fell below 2.4% in early October. Unfortunately, the decline in interest rates was reversed in the fourth quarter as yields backed up by over 100 basis points, decreasing the relative appeal of commercial real estate lending.<sup>1</sup>

State and local governments continue to face severe strains, with some municipalities seeking emergency assistance, and even contemplating declaring bankruptcy. At the state level, after facing a budget shortfall of \$110 billion in 2009, states had to close a gap of \$191 billion in 2010.<sup>2</sup>

## The Year Ahead

### 1. Meaningful growth

Decreased uncertainty plus fiscal and monetary stimulus are likely to drive meaningful economic growth in 2011. Forecasts for U.S. GDP growth in 2011 have been increasing in recent weeks, particularly on the back of the agreement to extend the Bush tax cuts for two years. This agreement, along with the decision to add a payroll tax reduction and accelerated write-offs of capital expenditures, will likely boost growth in the near term.

This growth could be sufficient to reduce U.S. unemployment by a material margin. During this so-called "Great Recession," U.S. companies cut their staffing by a much more significant degree than historical models would have predicted, given the decline in GDP. One Obama Administration official quantified the increase in unemployment as being 200 basis points more than economists would have expected, given the GDP decline. To the extent the fiscal and monetary stimulus can lift end demand for products and services, the government's efforts may well trigger a positive chain reaction. If business confidence increases enough to hire back some of the employees who were cut in the throes of the crisis, we could see pent-up demand from consumers be released, leading to even more hiring.

While Americans will have to tighten their belts for years to come in order to deleverage, no one should expect spending to come to a complete halt. Instead, we may see periods of increased savings, followed by periods of increased consumption when consumers feel more

confident about their financial position. After two years of weak demand, it is reasonable to believe that consumers will soon be ready to reward themselves.

In addition, U.S. companies have done an exceptional job squeezing more productivity from fewer resources. Typically, we see capacity utilization increase before companies add to headcount. In this cycle, capacity utilization remains very low on reported metrics, even while profitability has returned to prior peaks (excluding financials). Given the large amount of capacity, management teams appear to be in a position to make smaller incremental investments to increase production.

The good news is that companies may increase productivity merely by hiring new employees, without investing large sums in new facilities or other big-ticket investments. In an environment in which taxes have been reduced, money supply has increased and consumers may be ready for a brief period of indulgence. The implication for shareholders is that we believe we may see companies increase revenue and sustain the very high profit margins already achieved on a bigger base.

## 2. Not all growth is created equal

While we are optimistic about growth in the aggregate, it is important to recognize that QE2 and fiscal stimulus are benefiting some industries and socioeconomic strata much more than others. Fortunately for equity markets, averages matter. In 2011, we will likely see a continuation of an under-reported theme of economic and socioeconomic differentiation. Early reports from the holiday season already preface what we expect to see in the quarters ahead. Aggregate retail sales figures have been better than expected, while consumer confidence has been weaker than expected. Equity markets have risen to levels last seen before the collapse of Lehman Brothers, but unemployment remains stubbornly high and underemployment is even higher. What could cause such discrepancies in the data?

We are witnessing a phenomenon that is, in many ways, analogous to the supply-side economics seen in the early 1980s. Surprising though this statement might seem, taken alongside QE2, the tax policies embraced in the closing days of 2010 in some ways resemble what was somewhat derisively described as “trickle-down economics” 30 years ago. The primary difference between then and now is that this time we are combining a carrot and a stick: the fiscal stimulus (in the form of tax cuts) is the carrot and QE2 is the stick.

If we focus on the tax agreement, its total cost will add \$857.8 billion to budget deficits over the next ten years, according to the Congressional Budget Office. The Urban-Brookings Tax Policy Center has estimated the distribution of the tax reduction, versus what would have happened if all the tax cuts had expired. For the average tax-filing household, the benefit of the tax agreement, versus what would have happened otherwise, will be a reduction in taxes of \$2,823. For filing households with income of \$500,000 to \$1 million, the reduction in taxes will amount to \$25,024. For filing households with income over \$1 million, the reduction in taxes will average \$139,199.

Put in simple terms, the tax cuts will put a large amount of money in the pockets of the wealthiest Americans, with the assumption that they are best placed to invest the windfall in job-producing businesses and spend it on end products and services. The median filing household will likely spend almost all of the benefit, but the incremental spending from the wealthiest families will really determine if the cuts work.

Now, let's focus on the stick. QE2 involves the Federal Reserve's (the Fed) buying \$600 billion of net new securities (the other \$300 billion, reinvested from mortgage-backed securities, will not alter the net supply of debt available to the private sector). When the Fed buys these treasuries, it increases the amount of money in the system and reduces the supply of debt that can be bought. Effectively, the Fed is creating so much money that the cost of money declines in terms of interest rates. Put another way, the stick for the wealthy in this new iteration of trickle-down economics is that, while they will end up with more capital, they will be penalized if they sit on it in the form of cash, as cash yields are near zero. Moreover, given the fears of inflation (which we view as unjustified), the wealthy may have even more reason to put their money into riskier assets that are more likely to create jobs.

We believe the experiment is likely to work, but would caution that any unorthodox prescription comes with potentially risky side effects.

## 3. Unexpected side effects

While we are optimistic that the U.S. will see meaningful economic growth in 2011, QE2 and the fiscal stimulus agreed upon in December introduce new risks into the equation, while increasing the probability of a fat-tail risk event involving sovereign debt from the U.S.

On the back of the Fed's initiation of QE2, we began to contemplate new questions:

- Will quantitative easing be a global phenomenon, or will the Fed be acting alone? (So far, only the Bank of Japan has joined the Fed in QE.)
- If the Fed does end up acting alone, will QE2 be sufficient to achieve its underlying goals?
- Could there be goals beyond avoiding deflation in the U.S.?
- What if QE2 were to cause global commodity prices to increase, as investors fled fiat currency for hard assets?

- What if QE2 were to lead to a financial bubble in countries with high economic growth rates, as U.S. investors sought returns beyond their borders?
- Will central banks in other countries have to act to decrease money supply and tighten conditions?
- What if other countries were to tighten so much that their growth rates declined materially?
- What if commodity prices were to increase, effectively decreasing discretionary spending power for U.S. consumers?

We still do not have answers to all of these questions, but we have developed a series of key scenarios around QE2 that suggest a wide range of potential ripple effects, positive and negative.

The good news for investors is that these scenarios look disproportionately positive for equities. As noted above, the “trickle-down economics” of today includes a stick that strongly encourages investors to move their money into riskier asset classes if they want to earn any positive nominal return on their capital. We believe that the most likely scenario will be that financial assets, particularly equities, will appreciate further on the back of QE2. At the same time, we do believe that commodity prices may be sustained or even propelled higher as growth-seeking money flows into emerging markets and as investors buy hard assets as a hedge against the devaluation of fiat currency.

The fiscal package increases the risk that the U.S. could face interest-rate pressure on its own borrowings at some point, if foreign investors decide that the U.S. is not serious about addressing its long-term fiscal imbalances. Government debt outstanding in the U.S. has grown from 51% of GDP at the end of 2007 to 78% as of the end of the third quarter of 2010.<sup>3</sup> This trajectory cannot be sustained. The decision to increase the budget deficits by about \$800 billion over the next two years will add about 500 basis points to the debt/GDP, above and beyond the already-expected 1,200 basis points, which suggests that debt/GDP could reach 95-100% by the end of 2012.<sup>4</sup>

Effectively, the strategy is to try to kick-start U.S. economic growth with a large fiscal deficit—then use the window created by that interim growth to reduce long-term entitlement costs and significantly reduce the size of the U.S. annual deficit. While the U.S. has long been an exceptional country in many ways, we should not be under the illusion that we can perpetually spend more than we earn.

#### 4. Other risk factors

Beyond the risks emanating from QE2 and fiscal deficits, there are still other concerns ahead of us. These risks are important for us to monitor, as they could derail our positive scenario. Briefly, they include:

- **Residential real estate.** The latest S&P Case-Shiller Home Price Index data shows 6 cities hitting new cycle lows in house prices and 16 cities seeing prices decline from a year ago. We now expect to see the 20-city index hit new lows over the next year or two. The risk of home-price declines is that they beget more supply, as owners determine that they are too far underwater to ever resurface and choose strategic default as their resolution. The more prices decline, the more supply hits the market. The more supply on the market, the more prices decline. This vicious cycle remains a risk. Considering that about two-thirds of American households own their own home, and that it is their single biggest asset, housing prices truly are the weak link in the bullish economic story above.
- **Commercial real estate.** Prices stabilized in 2010 and even ground higher as interest rates hit new multi-decade lows and investors sought yield. Unfortunately, with interest rates backing up in the fourth quarter, we are worried that commercial real estate prices could resume their slide. The positive offset to interest rates is that we might see enough economic growth to absorb some of the vacant commercial space on the market, increasing cash flow on the assets and decreasing default risk.
- **State and local government deficits.** State governments in particular have suffered over the last few years as property tax revenue has been slammed and sales and income tax revenues have slipped. Unfortunately, the Center for Budget and Policy Priorities reports that state budgetary gaps are likely to remain, with the most recent estimated gap for 2011 at \$130-160 billion, and 2012 at \$113-140 billion. Put simply, with 49 states required to balance their budgets each year, these gaps mean more tax increases, spending cuts or some combination of the two.

## The Secular Backdrop

### Theme #1: Deleveraging continues

The private sector—in particular, the financial sector and households—continues to make solid progress in cutting its debt/GDP ratios. Financial debt/GDP has declined by 2,300 basis points from its peak, while consumer debt is down 700 basis points.<sup>5</sup> Partially offsetting this is the government sector. Exhibit 1 shows the evolution of debt by sector since Q1 2009.

## Exhibit 1 U.S. Debt by Category

	2009 Q1		2010 Q3	
	(\$ trillion)	(% of GDP)	(\$ trillion)	(% of GDP)
Total Debt	51.0	363	50.3	341
Government Debt	9.0	64	11.5	78
Financial Debt	17.0	121	14.4	98
Consumer Debt	13.8	98	13.4	91
Corporate Debt	11.2	79	11.0	74

As of 30 September 2010

Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department

Significantly, if the economic strength we expect to see in 2011 is sustained, we see reason for optimism regarding deleveraging. If GDP were to grow 3.5% per annum in 2011 and 2012, and government deficits were to run \$1.4 trillion per year while private sector debt levels remained unchanged, U.S. debt/GDP could decline to 318% from its current 341%.<sup>6</sup> While not a huge improvement on the face of it, the point is that growth in GDP, the denominator in the equation, is a powerful factor in deleveraging. The strategy is to grow the denominator to allow us time to address the strategic challenges of long-term deficit reduction.

### Theme #2: Reregulation is underway

With healthcare and financial regulatory reform signed into law, the focus now is on implementation. The news in 2011 is likely to lead with political disputes over funding for the new agencies and policies.

Key elements of financial regulatory reform still to be decided include the definition of proprietary trading under the Volcker Rule, as well as which firms will be deemed “systemically important financial institutions” (SIFIs). The designation of SIFIs will have further implications under Basel III, as these institutions may be required to hold even more capital than their smaller peers to reduce the risk of a repeat of the Lehman Brothers failure.

### Theme #3: Widening divergences

This secular driver is a new one, although we have been contemplating it for some time. The idea of widening socioeconomic gaps has been around for decades, but it is growing in prominence in both the economic and political universes. This is no longer just about economic outcomes. Instead, it relates to a range of growing “gaps” between categories of people based on:

- **Educational attainment.** This recession has highlighted the stark difference between college-educated Americans and those with less education. The 29% of Americans over the age of 25 with a college degree have an unemployment rate of 5.1%—a rate that is over three times its low in 2000, when it was only 1.5%. For the 26% of Americans over 25 with some college but no degree, the unemployment rate is 8.7%, versus 2.4% in 2000. For the 31% of Americans with only a high school diploma, the unemployment rate is 10%, versus a low of 3.2%, in 1999.<sup>7</sup> Simply put, the economy is strongly discriminating, based on education.
- **Age.** The demands on governments at the local, state and federal level are increasing, even while revenue has been weak. The diverging needs and wants between voters and people who are too young to vote but will drive the future strength or weakness of the U.S., are becoming clearer. Entitlement issues will likely be a flashpoint of this age-related divide at some point in the next few years. Europe has already seen what happens when government raises the retirement age. The U.S. will face similar decisions.
- **Public-versus private-sector employees.** The newest divide is between government and private-sector employees. Benefits for government employees’—pension and healthcare benefits in particular—are in sharp focus in many cities and states that are struggling to plug budget gaps. We expect this issue will also be a hot topic in the year ahead.

## Conclusion

As uncertainty regarding the outlook has decreased through 2010 and as investors have begun to re-engage riskier assets such as equities, we continue to be optimistic. The combination of improved visibility, fiscal stimulus and monetary stimulus is likely to lead to meaningful economic growth in the U.S. in 2011, with potential for strength to be sustained into 2012. While we see strength in aggregate indicators, we expect substantial differentiation in performance among and within different asset classes and socioeconomic/demographic sectors.

We also believe the unorthodox prescriptions for the current economic malaise may have unexpected side effects. We believe the “trickle-down economics” of the 2010s may well prove to be effective, but largely because of the carrot-and-stick approach of leaving more money in wallets but simultaneously penalizing that money if it does not leave the wallet for riskier territory.

Risk factors such as residential real estate price weakness, the potential for another swoon in commercial real estate prices and the ongoing stress at the state and local government levels could all dampen or even derail growth prospects.

That said, we are optimistic that the U.S. economy will make real progress in 2011 while also continuing the process of deleveraging, and while applying new regulations, and Basel III capital requirements, to the largest banks. The biggest challenges still lie beyond our immediate time horizon, as growing gaps within the population in terms of both needs and outcomes will clash with long-term fiscal realities.

In the interim, we see a window of opportunity that bodes well for investors who rely on forward-looking fundamental research and who contemplate the range of scenarios that might occur, given different economic and company-specific conditions. Combining these process characteristics, we believe there are bright prospects for companies with strong balance sheets and cash flow and the resulting operational flexibility to gain market share and increase future profits.

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## Notes

1 Source: Bloomberg, as of Q4 2011

2 Source: Center on Budget and Policy Priorities, as of 16 December 2010

3 Sources: Federal Reserve, CBO, and Bloomberg, as of 30 September 2010

4 Source: LAM estimates and CBO, as of 31 December 2010

5 Sources: Federal Reserve and Bloomberg

6 Source: LAM estimates, as of 31 December 2010

7 Sources: U.S. Census Bureau and U.S. Bureau of Labor Statistics, as of November 2010

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