April 2011

Outlook on the **United States**

In our last quarterly outlook, we introduced a new secular theme, widening divergences, alongside deleveraging and reregulation. That concept of widening gaps resonates from multiple facets. The current budgetary and economic strains are highlighting the widening differences between the priorities of the elderly and the young, between public sector employees and taxpayers generally, and most importantly, between the wealthiest Americans and the average household.

Intriguingly, much of the strategy currently being deployed to restart the U.S. economic engine relies on wealthy individuals responding to a combination of fiscal and monetary stimulus. We have previously referred to these stimuli as "trickle-down economics à la Obama, Boehner and Bernanke."

In this outlook, we focus on quantitative easing (QE), its stated and perhaps unstated goals, and the mechanisms through which it might work, including the implications for the widening gap between the "have-yachts" and the "have-nots." We then explain why we believe it is pivotal to employ QE to mitigate the pain of the long deleveraging ahead, even if there is no guarantee that QE will be effective.

Trickle-down economics à la Obama, Boehner, and Bernanke

We have noted in the past that the newest iteration of "trickle-down economics" is different from that of the Reagan era, in that this time there is both a carrot and a stick.

1. **The carrot = tax cuts.** American households, particularly the wealthiest ones, are able to retain more of their income, due to the two-year extension of tax cuts agreed to in the closing days of 2010. As a reminder, for a household with taxable income exceeding $1,000,000, the reduction in taxes, due to the extension, averages $139,199. By comparison, the average American household is estimated to save $2,823 from the tax cut extension.[1]
2. **The stick = low interest rates.** The Federal Reserve (the Fed) will continue its efforts to maintain near-zero short-term interest rates and to decrease the yield on Treasurys through its bond purchases, commonly referred to as QE2[2]

Effectively, American households, especially those with the highest incomes, are benefiting significantly from the extended tax cuts—but they are also facing pressures created by the Fed to deploy their extra after-tax income to riskier assets, rather than to bank accounts or money market instruments.

The goals of QE

When the Federal Open Market Committee (FOMC) announced QE2 on November 3, 2010, the press release read:

"To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to expand its holdings of securities. The Committee will maintain its existing policy of reinvesting principal payments from its securities holdings. In addition, the Committee intends to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability."

This statement represents the ultimate goal of QE, but there are a number of intermediate steps along the way to achieving this goal, each of which has implications if the program is successful.

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The other objectives of QE include:

- Decreasing the risk of deflation, which might result from deleveraging and a decrease in the velocity of money
- Arresting the decline in prices for certain hard assets, such as residential and commercial real estate, by sustaining near record low mortgage rates
- Prompting the easing of credit underwriting terms, in a subtle way, by forcing lenders to take more risk to earn an acceptable yield from their assets

The objectives above are not terribly contentious. That said, there are other potential objectives that might be considered controversial. They include:

- Laying the groundwork to decrease global imbalances over the long-term by allowing commodity prices and other inputs into the production of goods to increase substantially, with a disproportionate impact on emerging markets. Interestingly, this potential side effect of QE could be seen from an economic perspective as an alternative to the revaluation of certain currencies, such as the renminbi.
- Increasing the competitiveness of less-skilled American labor by allowing or even increasing inflation rates for hard assets, thus devaluing the income of the typical worker. Alternatively, this devaluation of less-skilled American labor wages, in real terms, may make U.S. employees more competitive.

The mechanics of QE

While the first sentence of the FOMC announcement from November 3 sounds simple enough, the actual mechanics of how QE2 is intended to promote a stronger pace of economic recovery need further explanation.

To understand how quantitative easing works, it is best to start by working through the food chain of financial markets, given that the Federal Reserve is buying Treasurys. If we think back to the 1980s, a common fear was "crowding out." The concept was that fiscal deficits run by the government would absorb so much of the available savings that businesses needing credit would have to pay interest rates so high that they would be "crowded out" of the markets.

Ironically, in the current downturn, the idea is to crowd savers out of the least risky assets. By buying Treasurys, the Fed is working to force savers to move their money into riskier financial assets—or, better yet, to invest those funds in businesses or in consumption. Clearly, consumption is a direct boost to the economy, but the reality is that few people respond to a Fed purchase of Treasurys by going shopping.

When the Fed depresses the yields on Treasurys by buying large amounts of the net new supply, it encourages investors to move to other parts of the financial markets in search of higher returns. It is important to realize that financial markets are global and encompass debt, equities, currencies and commodities and that investors may reallocate their funds from one asset class to another.

The least significant effect of Fed Treasury purchases would be to force investors to buy agency or corporate debt rather than government debt. That switch may add some extra yield, but to the extent the Fed creates more demand for corporate or other debt, there is a waterfall effect in which the investors who had previously been happy with that category of debt instrument find the yields depressed and subsequently are forced out the risk curve.

Ultimately, prices for all financial assets rise, even though the Fed has only purchased Treasurys. While it is impossible to quantify how much lower the S&P 500 Index and a wide range of other financial asset prices might be without QE2, we strongly believe that prices are higher than they would otherwise have been, compliments of the announcement of a $600 billion purchase program, and the subsequent deployment of over $477 billion through March 28, 2011 to purchase Treasurys.[3]

As is often the case with policy actions, QE can also have unintended consequences—such as higher prices for non-perishable commodities or those that can be stored and function as hedges against inflation risk. Examples of such non-perishable commodities include oil, metals and other products that can be stored for extended periods of time. The reason these commodity prices are likely to be boosted by QE is that investors who fear the old maxim that too much money chasing too few goods leads to inflation, rationally see QE as heightening the risk of a devaluation of fiat currency[4], the U.S. dollar in this case. To protect themselves, they purchase commodities either in physical or derivative form, worsening the very inflation they seek to hedge against. Speculators alone are unlikely to drive prices materially higher, but when combined with increasing demand from the growing middle class in emerging markets, we believe it is easy to foresee sustained price increases for a wide range of commodities, from food and fuel to metals.

This inflation in hard assets is partially intentional. To the extent higher commodity prices engender a fear of headline inflation, the Fed may claim success in terms of avoiding a deflationary spiral. The challenge with this logic is that higher commodity prices (be they food, fuel or otherwise) may well end up leading to decrease in discretionary spending power for the average household.

How the money trickles down

The mechanics of QE do not stop with commodity prices, however. As noted above, a logical outcome of massive Fed financial asset purchases is higher prices for those assets than would be seen otherwise. This is where the story around widening divergences becomes much more relevant.

Every three years, the Federal Reserve releases its Survey of Consumer Finance. This survey compiles data on the assets, debts and net worth of American households broken down by many factors, such as education level, employment, net income and net worth. The most interesting information, as it relates to the discussion of trickle-down economics, is found in the data regarding assets and debt stratified by household net worth. By definition, the top decile of households by net worth is clearly wealthy.

As shown in Exhibit 1, household assets in the United States, as of the last report, totaled approximately $62.6 trillion. Of this amount, the top decile held 71.4% of the assets, while the next 15% of households held an additional 15.8% of assets. The next quartile of households owned 10.2% of assets, leaving 2.6% of assets in the bottom half of the households in the U.S. While it is well known that the wealthy have a disproportionate share of assets, the composition of those assets is not widely known.

As shown in Exhibit 2, the vast majority of Americans have very little exposure to financial assets.[5] The bottom 75% of American households owned only 11.5% of the financial assets of households in total, or an average of approximately $34,400 in 2007. By comparison, the typical household in the top quartile of net worth held financial assets worth approximately $788,000. The top-decile households held an average of $1.6 million.

Clearly, to the extent the Federal Reserve is driving up financial asset values through QE, it is directly benefiting the wealthiest Americans. Taking this balance sheet benefit into account, alongside the income statement benefit of the tax cut extension agreed at the end of 2010, we believe it is clear why we refer to the current program as trickle-down economics.

Why would the Fed and Treasury focus so much on the highest-net-worth households, when they are the ones who are best positioned to handle a downturn? One answer is that these households drive a disproportionate amount of discretionary spending and are more likely to increase their expenditures, especially when they enjoy higher after-tax income and a wealth effect from improved balance sheet conditions. The second reason, which is more compelling, is that these households generally comprise the decision-makers in the U.S. economy.

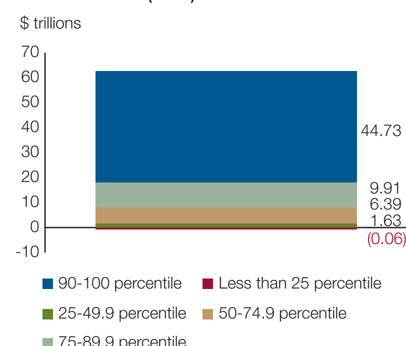
As can be seen in Exhibit 2, approximately 48% of American households in the top decile of net worth owned interests in businesses that are not publicly traded (publicly traded equities would be included in financial assets). These business interests could range from the local dentist or other small business owner to the partners of a large private equity or law firm. That said, with an average net worth of just under

Exhibit 1 Distribution of Net Worth by Cohort

Mean Net Worth ($000s)

	Less than 25 percentile	25-49.9 percentile	50-74.9 percentile	75-89.9 percentile	90-100 percentile
1989	-1.0	37.0	143.3	363.8	1,999.3
1992	-0.8	36.8	131.1	316.3	1,807.9
1995	-0.2	41.4	134.7	322.6	1,943.2
1998	-2.4	45.7	163.7	410.1	2,468.4
2001	0.1	51.9	195.6	528.3	3,235.7
2004	-1.6	51.7	204.0	580.7	3,427.6
2007	-2.2	58.1	227.7	588.6	3,985.9
CAGR (%)	Not Meaningful	2.5	2.6	2.7	3.9

Total Net Worth (2007)



As of 2007

Source: Federal Reserve "Survey of Consumer Finances," Census Bureau

$2.5 million, it is clear that many of these individuals may make the decisions regarding hiring of new employees and capital investment. To the extent they feel wealthier and enjoy higher income, the idea would be that they would loosen the "purse strings" and invest in growth, creating a virtuous cycle of new jobs and higher consumption from people deriving wage increases or getting new jobs altogether.

Why ongoing QE is pivotal to success in deleveraging

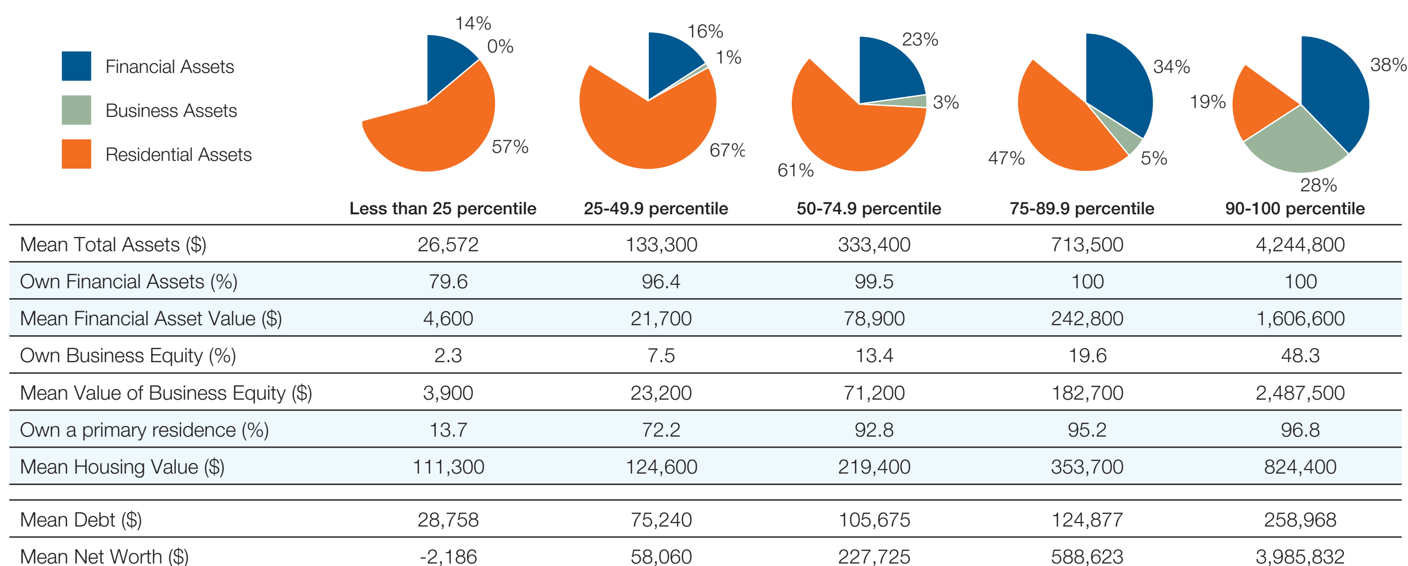
While the arguments behind the idea of wealth trickling down are reasonable, it should also be clear that success is not a given. In spite of this uncertainty regarding success, we would argue that QE is necessary to mitigate the deflationary pressure of deleveraging. We have discussed the topic of develeraging at length in the past, but suffice it to say that the United States is only in the early innings of a lengthy process of managing debt outstanding down to sustainable levels. To date, the consumer has decreased total debt outstanding from over 98% of U.S. GDP, to just below 90%, as of the end of 2010.[6] The financial sector has deleveraged much more—from 121% of GDP to just below 96% as of the end of 2010. This deleveraging process reflects a decrease in end-demand for goods and services from the consumers and the financial institutions that extend credit to them, as well as write-offs of debt deemed irrecoverable. To cushion the blow of such a sharp decrease in demand, the federal government has run large deficits, increasing government debt to GDP, from just under 45% at the end of 2008 to just over 63% at the end of 2010.[6]

Alongside the fiscal stimulus, the Federal Reserve has also engaged in a range of unconventional monetary stimulus efforts since 2008. The combined fiscal and monetary stimuli are designed as a bridge until the consumer resumes spending. At some point in the not-too-distant future, the fiscal stimulus in particular will have to decrease substantially in size. The most likely point of such a return of fiscal restraint will be at the end of 2012, when the tax cut extension expires. In the interim, the U.S. federal government is likely to have increased its debt/GDP by as much as 2,000 basis points and will have little choice but to cut spending and raise taxes.[7]

It is important to recognize that the building of momentum in the U.S. economy in recent quarters has been driven in large part by the combination of fiscal and monetary stimuli. The goal of deficit spending at the federal government level has been to attempt to sustain demand for goods and services and ultimately to sustain private households. Monetary stimulus has been focused on lowering interest rates and easing access to credit, to help companies and households refinance their debt to lower rates, increasing their cash flow net of debt payments. The goal is that the combination of fiscal and monetary policies will kick-start the private sector economy sufficiently to generate jobs and sustain itself after the stimulus packages have ended.

To put the stimulus packages into perspective, consider one specific scenario. We assume that the federal government runs annual budget deficits of $1.4 trillion per year in 2011 and 2012 and that debt levels for all other American borrowers remain unchanged through the end of

Exhibit 2 Distribution of Assets by Cohort



	Less than 25 percentile	25-49.9 percentile	50-74.9 percentile	75-89.9 percentile	90-100 percentile
Mean Total Assets ($)	26,572	133,300	333,400	713,500	4,244,800
Own Financial Assets (%)	79.6	96.4	99.5	100	100
Mean Financial Asset Value ($)	4,600	21,700	78,900	242,800	1,606,600
Own Business Equity (%)	2.3	7.5	13.4	19.6	48.3
Mean Value of Business Equity ($)	3,900	23,200	71,200	182,700	2,487,500
Own a primary residence (%)	13.7	72.2	92.8	95.2	96.8
Mean Housing Value ($)	111,300	124,600	219,400	353,700	824,400
Mean Debt ($)	28,758	75,240	105,675	124,877	258,968
Mean Net Worth ($)	-2,186	58,060	227,725	588,623	3,985,832

As of 2007

Source: Federal Reserve "Survey of Consumer Finances," Census Bureau

2012. If inflation were 2.5% and real GDP growth were 3.0%, U.S. debt/GDP for the entire economy would decline from 340% at the end of 2010 to 322% by the end of 2012. While that might not sound like amazing progress, it is actually quite good considering that debt/GDP peaked in the first quarter of 2009 at 363% of GDP. It also presumes that in spite of significant real GDP growth, the federal government sees no major improvement in tax revenue or a reduction in spending on unemployment benefits, food assistance and other social safety nets.

This combination of fiscal and monetary tools in the United States stands in stark contrast to the situation in the euro zone, where countries cannot issue their own currency. In the cases of Greece, Ireland and Portugal, among others, the governments attempted to follow the same game plan as the U.S. They ran large fiscal deficits to cushion the decrease in private sector demand through the Great Recession. Unfortunately, for these countries, debt market investors lost confidence in the efficacy of fiscal stimulus to generate enough economic growth to reduce debt levels in the longer-term. As the countries were unable to print the currency to fund their deficits, they have been forced to engage in fiscal austerity programs that are very painful for much of their populations.

The U.S. has been able to use both monetary and fiscal tools, but cannot presume that both sets of tools have an unlimited lifespan. The first tool that is likely to be withdrawn is the fiscal stimulus, as the public is increasingly alarmed by massive fiscal deficits driven by elevated spending and low tax rates. The CBO estimates that the federal budget deficit in the U.S. in 2011 is likely to be a record $1.4 trillion or over 9% of GDP.[8] When the federal government truly shifts out of stimulus mode, the impact on the private sector will be meaningful and negative in the short-term as federal spending on goods and services from private sector companies declines, transfer payments to households decline and tax rates on individuals and companies rise.

If the Federal Reserve were to reduce or even eliminate its monetary stimulus efforts before or at the same time as the end of fiscal stimulus, the economy could well slide back into recession. Given the underlying fragility of the economic growth we have seen so far, we believe it is imperative to remove the monetary stimulus only after the federal fiscal stimulus has been withdrawn. The goal of removing stimulus in a sequential, rather than simultaneous manner, is to give the private sector time to adjust to a new, less accommodative operating environment and transition to a more normal situation in which the government is not the primary driver of economic momentum.

Put simply, this economic cycle is unlike anything seen since the Great Depression. We believe success in terms of stimulating the economy will not be measured in terms of months of unemployment declines but rather in the degree to which deleveraging has been accomplished and employment has approached the level generally accepted as full employment.

What could go wrong?

In the interim, we believe that the U.S. economy, while currently growing again, faces far too many threats to its vitality to withdraw the monetary stimulus. To name only a few, there are risks related to:

- Elevated levels of unemployment and high levels of leverage
- The potential that the measures employed to stimulate the economy fail
- Sovereign debt concerns, particularly in Europe, which could force an early end to fiscal stimulus in the U.S., or worse
- Geopolitical risk arising from the conflicts in the Middle East
- The elevated price of oil due to Mideast tensions, as well as to a decreased willingness to rely on nuclear power in the aftermath of the Tohoku earthquake

Even though QE's success is not a given, in our view, no QE greatly increases the chance of failure.

Given that the combination of fiscal and monetary stimulus might not succeed, one might ask what will happen if the efforts fail. The first item to address is what the definition of failure would be. The Fed's stated goal, "To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate," might be a good starting point.

As we indicated above, there are a lot of steps between QE and achieving these goals. Perhaps a better way to define success would be seeing a sustained increase in employment alongside continued deleveraging, even if it is largely due to growth in GDP rather than reductions in debt outstanding. Put another way, this effort is largely focused on kick-starting growth rather than on implementing severe austerity moves.

If the U.S. were to see subpar economic growth and/or a disappointing improvement in the employment situation over the next one to two years, one could argue that QE has not achieved its immediate goals. If that were to be the case, it is tough to argue a positive story for the progression of deleveraging, especially at the federal fiscal level.

What does all of this mean for investors?

U.S. equities have outperformed global markets for two consecutive quarters. Part of this outperformance has been driven by the budding economic momentum in the United States. Adding to the upside has been a sharp rebound in corporate profits that has only begun to be recognized in share prices in recent quarters. We could have argued that profitability justified higher equity prices early in 2010, but the markets faced a wall of uncertainty. As the rally continued through the first quarter of 2011, we saw some of the undervaluation resolved in U.S. equities.

In spite of the recent rally, we continue to see reason for optimism for U.S. equities. If we consider equities versus fixed income instruments, the risk/reward remains asymmetric for much of the fixed income universe, especially considering the degree to which the Federal Reserve and other central banks arguably are distorting yields downward. If QE is effective as we have described earlier, the legitimate expectation should be for economic growth to put downward pressure on bond prices and upward pressure on yields. If QE fails, one could argue that credit quality concerns will resurface in a significant way as investors question what will lead to economic growth.

Regarding the equity universe, we believe the U.S. is in a positive position as it is already enjoying meaningful real economic growth and seeing the early signs of job growth. To the extent this economic growth gains traction, there would likely be further legs to the upside story as demand recovers from newly re-employed workers. To the extent the bet on growth in GDP works, the deleveraging we have discussed at length can proceed, as the debt outstanding is divided by a bigger and bigger denominator of economic output.

If the U.S. does not sustain its current economic growth, the most likely reason would be an exogenous variable such as sovereign debt issues in Europe, derailed growth in emerging markets as central banks fight inflation or an oil price spike to levels unseen in the past on the back of violence in the Middle East. In each of these negative scenarios, one could argue that the U.S. might be the least bad equity market, as it would decline on a secondary, rather than a primary basis.

Conclusion

Taking it all together, the U.S. has gained some positive momentum that has lately begun to be reflected in share prices. The current combination of fiscal and monetary policy is effectively a bet that, by improving the balance sheets and income statements of the wealthiest Americans, the "have-yachts," growth will trickle down to the rest of the country. While there is no guarantee QE2 (or whatever iteration might follow) will succeed, we feel there is at least a reasonable probability of a good outcome.

Through this period of uncertainty, the U.S. and much of the developed world will continue the deleveraging process. At some point, the public sector will stop subsidizing private sector spending and the tide will likely reverse so that the private sector will subsidize the deleveraging of the public sector.

In the background, developed countries will continue to re-regulate the financial sector even as they continue to reconsider how to regulate and manage the healthcare and energy sectors.

Until the process has been completed, we are likely to see a continuing widening of the divide between the truly wealthy and everyone else. This process in and of itself may well lead to an entirely different set of challenges in the form of tax systems more focused on redistributing income, protectionism or a host of other backlashes.

Through all of this, we continue to focus on identifying excellent investment opportunities in the form of companies that have the balance sheet strength, robust organic cash flow and operational flexibility to survive and thrive regardless of the economic, political and regulatory backdrop.

Notes

1 Source: Urban-Brookings Tax Policy Center

2 The current purchases of Treasurys is commonly referred to as QE2 and comprises $600 billion of purchases funded with new funds and an additional $300 billion of purchases funded with the proceeds of cash flows from interest and maturities of Mortgage Backed Securities (MBS) purchased as part of the first round of QE. The prior QE program was announced in the second half of 2008 and included $1.25 trillion of MBS and $200 billion of debt issued by Fannie Mae and Freddie Mac.

3 Source: newyorkfed.org

4 Fiat currency is currency that has value only because of government regulation or law. In other words, it is not backed by hard assets such as gold.

5 Financial assets comprise a wide range of ownership interests including but not limited to equities, bonds, money market funds, insurance policies, bank deposits, pension funds, ownership in noncorporate businesses and other non-physical assets. Financial assets when added to tangible assets (which include net equity in a home, automobiles and other physical assets) comprise all household assets.

6 Source: Federal Reserve Flow of Funds Report

7 Source: Congressional Budget Office (CBO) estimates and LAM estimates

8 Source: www.cbo.gov

Important Information

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