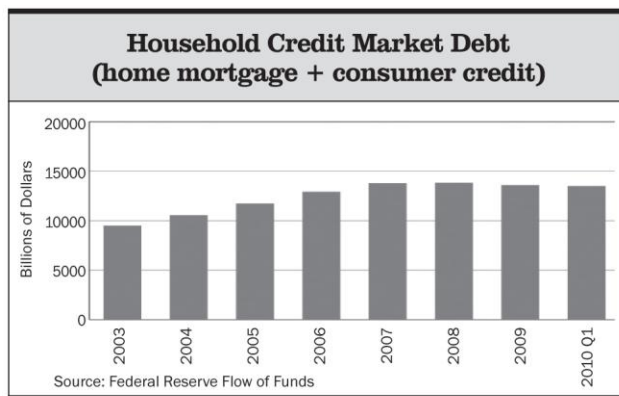


The Deficits vs. Austerity Debate

It's no secret that there is too much debt in most of the developed world—the United States, Europe, and Japan. That the problem is identified doesn't lessen the challenge. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household debt relative to income remains high. Most of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun. (Some countries that don't have high private sector debt do have huge public sector debt that must be reduced—Japan is the most prominent example.)



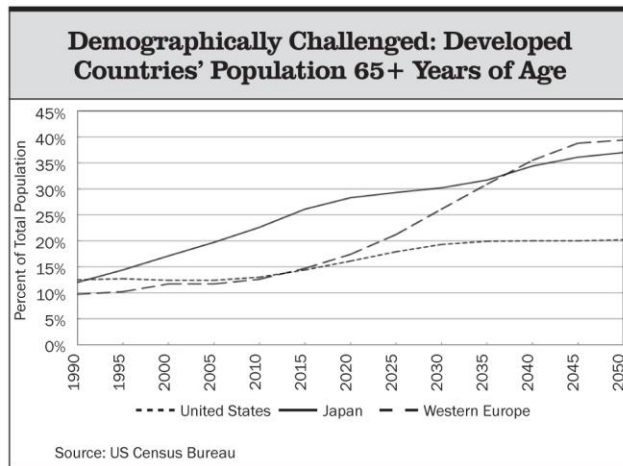
Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).

The timing and aggressiveness with which public sector debt and deficits are attacked will be tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline. The risk is that some or all of the benefit of reduced government spending is offset, undermining the goal of reducing debt while also resulting in more short-term

economic stress.

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the country and a ripple effect that in a global economy has reached far beyond Greece's borders. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time.

Slowing and ultimately reversing the growth of debt is further complicated by aging populations—a reality that most of the developed world faces to different degrees. An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States).



A large portion of Japan's population is over 65 and the percentage will move sharply higher in coming decades. Europe's demographics are not too bad at present but are set to get sharply worse over the next 30 years. The U.S. population is also aging and though the 65+ age group will be a much larger percentage of the total population in 25 years, we will be much better off than Japan.

While the private sector gradually delevers, and we wait for the public sector to later do the same, at least the United States is experiencing an economic recovery, albeit a tepid one. There has been clear improvement from the depths of the recession. The economic cycle is, for now, a plus, but the big problems have not been resolved. Several interrelated factors are the reason that the rate of economic improvement has not been impressive in the aftermath of such a severe recession. That leaves the level of most economic measures still looking lackluster—even though there is improvement.

Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets,

credit growth, and housing—remain weak.

- We are still down about eight million jobs from the peak and in the private sector job growth is barely positive—though that is an improvement from last year.
- Credit market debt is contracting as it has been for about two years, which removes an important driver of consumer spending.
- Housing continues to be critical to household financial strength and the banking sector. The outlook remains cloudy and appears to be pausing with the expiration of the homebuyer tax credit.

The rest of the developed world looks worse. Europe is experiencing very slow growth, southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis, and economic policy is a challenge given a single monetary policy in the eurozone, but no political union and differing economic situations.

Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus, healthy corporate balance sheets and cash flow, and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

This all nets out to a macro environment that while improving, is still fragile with intermediate-term challenges. It remains unclear whether the U.S. recovery has a strong enough foundation to continue to gain strength as the federal stimulus is withdrawn later this year, the inventory rebound cycle ends, and the debt-related stress points remain. A continued recovery is likely but not assured and a robust recovery still seems unlikely. Finding the right balance between addressing deficits and growth will be tricky, but we believe it is made many times tougher given political pressure that is based more on politics than a sophisticated understanding of the

complexity of the issue and what is best policy. The risk of policy errors remains and could come through fiscal policy, monetary policy, and/or regulation.

So our view of the big-picture environment we face in the next few years is unchanged. The recovery continues but it is not inspiring, and we see above-average macro level risk in spite of being early in a recovery cycle. If the recovery is sustained, which is more likely than not, we still face intermediate- and long-term questions that make a wider-than-typical range of outcomes possible.

The large amount of public-sector debt throughout most of the developed world will be a major challenge for the global economy. How it is handled is one wild card in the tension between deflation and inflation. We are not concerned about inflation in the near term—there is too much excess labor and productive capacity—though it is more of a concern down the road.

This means that it is very possible that we will continue to face above-average uncertainty regarding economic growth rates, inflation rates, and interest rates not only in the short term, but also the longer term. For these reasons, we are sympathetic to the view that we may be experiencing a paradigm shift into a difficult period that does not include the robust economic recoveries we've come to enjoy after recessions. Moreover, there could be an economic handoff in the coming decade and beyond to the emerging world, parts of which are characterized by stronger balance sheets and a move towards self-sustaining growth. The rise of the emerging world needn't be a negative—it is not a zero sum game—but the pain of the developed world is still likely to be felt. If this is the case, investors will face a very challenging environment for years to come but also one that may at times offer significant opportunities.

Source: Litman/Gregory Asset Management