

Gary Shilling: Recovery is a Year Away

By Robert Huebscher

July 7, 2009



Among economists, Gary Shilling owns one of the most prescient forecasting records, having accurately predicted the credit crisis and the performance of key asset classes over the last several years. Now, he says, the chances that the current wave of “green shoots” will be the finale to the recession are “pretty low.”

Shilling delivered his latest forecasts when he spoke at the *Forbes* Advisor Conference last week.

Of the 11 post-World War II recessions, eight of them had at least one quarter of GDP growth. “Recessions are not a straight down affair,” Shilling said. “They go back and forth.” Stocks follow the same pattern as the economy, he said, and bear market rallies are the norm, not the exception.

Excess housing inventories will hinder recovery for at least a year. Due to the long period of overbuilding, housing inventories are approximately 2 million higher than normal. “Excess inventories are the mortal enemy of prices,” Shilling said. He predicted that more home equity will be wiped out, causing additional walk-aways and further problems for mortgage lenders.

“If nothing happens to get rid of housing inventories, it will be the end of 2010 before inventories are worked down,” he said.

Shilling said, half-seriously, that excess housing could be bulldozed, though he noted that a financial institution in Austin, Texas, did just that. Fire sales can clear inventories, but only at the expense of knocking down prices in the rest of the neighborhood. Although he suggested, in an op-ed piece in *The Wall Street Journal*, that excess inventories be sold to immigrants with H1 visas in return for permanent resident status, he conceded that anti-immigration sentiment would not allow it.

Time is the only catalyst to reduce housing inventories.

Housing prices are down 32% from their peak; Shilling forecasts a 37% decline but warned that it could overshoot. “This is very debilitating and a strong depressant of consumer spending,” he said.

Indeed, consumer retrenchment will impede economic recovery. Shilling recalled how consumers reduced their savings rates in the 1980s and 1990s, using their equity



portfolios as a source of wealth, and then seamlessly shifted to borrowing against residential real estate. Now, the average individual with a mortgage and 50% equity at the market peak has seen his equity dwindle to 22% -- with a decline to the mid-teens likely to come.

Consumers today have no alternative but to save, Shilling said, and as a result will spend less for goods and services. Production cutbacks will result, causing layoffs and wage cuts, which in turn will lead to further cuts in spending.

"This is a vicious cycle that must be broken before we get out of this mess," Shilling said.

Fiscal stimuli are the logical solution, but Shilling is not satisfied with the efforts so far. In the first \$787 billion package passed by Congress, he said, only \$200 billion went toward true stimulus spending – infrastructure projects, increases in unemployment benefits, or tax cuts. The remainder went toward the Obama administration's social agenda, and will not lead to increased consumer spending.

A byproduct of reduced spending will be deflation, which has been a consistent theme in Shilling's forecasts for the last decade. Declining commodity prices – led by decreases in the price of oil – and excess inventories will be the main drivers of deflation. Shilling said that, for the first time since the 1930s, employers have responded to the recession with wage cuts and shorter employee hours – instead of layoffs – and this, too, will fuel deflation.

Successful investing will hinge on positioning portfolios to defend against deflation. Traditionally, nominal bonds perform well in deflation, but Shilling warned that the rally in Treasury bonds is over. Instead, Shilling recommended focusing on sectors of the equity markets. Technology will be an "interesting play," he said, especially among companies offering products to improve productivity. "In deflation, companies cannot raise prices to increase profits, so they must reduce costs," he said, and productivity enhancing hardware and software does that.

Another area Shilling recommended was consumer staples. "If prices are coming down, consumers may cut or delay discretionary purchases like autos, cruises, appliances, and airline travel," he said. But staples must be purchased regardless of price.

Shilling said to avoid companies with a lot of debt, as it will be more costly to service in a deflationary scenario. Consumers are already treating monthly payments on their own debt as discretionary, and Shilling advised against investing in the consumer finance industry.

The U.S. dollar and Treasury bonds will retain their value and status as a safe haven, mostly because they are the "best of a bad lot," Shilling said. The sell-off of Treasury



bonds since March, when many who believed the recession was over increased their appetite for risk, was “temporary.” The dollar will recover, he said.

Shilling warned that “commodity currencies” – those of New Zealand, Australia, and Canada – will be weak as dampened worldwide consumption levels will depress commodity prices. “China is not going to buy up all the commodities in the world,” he said. The British pound will suffer because of the UK’s oversized financial sector (15% of its economy, as opposed to 5% of the US economy). And the Euro “has its own problems because of its one-size-fits-all structure,” he said. Individual countries – especially Spain, Portugal, Ireland and Italy – cannot cut interest rates to deal with economic weakness. As a result, they must take on more debt, increasing the likelihood of ratings downgrades and that they will drop out of the ECU and go back to their own currencies.

Investors should not worry about if or when China will stop buying U.S. Treasury debt; it will not happen, Shilling said, because “the Chinese are not suicidal.” If the Chinese moved away from investing in dollar-denominated assets, the U.S. currency would collapse and trigger a global Depression. The Chinese, whose economy is utterly dependent on exports, would be the big losers.

The U.S. economy has been the consumption engine powering the world economy, but that leadership came at the expense of reduced personal savings and increased consumer debt. Most thought the end would come when the Chinese stopped taking dollars. Instead, as Shilling said, the end came when the U.S. consumer hit the wall.

Now the Chinese want to export, but the U.S. does not want to import – and the U.S. wants to export as well. If everyone wants to export, the logical result will be protectionism. “This will be very unfortunate and will lead to slower growth in the long run,” Shilling said. “Protectionism is a very real threat.”

Shilling echoed the forecasts of PIMCO’s Bill Gross and others, who foresee a “new normal” – GDP growth of 2% – not the historical average of 3.6% and not high enough to prevent rising unemployment. Shilling expects the federal government to play a bigger, “chronic” role in preventing high unemployment, because politically it cannot afford to have the jobless rate rise year after year. He did not say what measures this chronic intervention would take.

The recession’s shape will be more like an L, Shilling said, with slow recovery and muted growth. “I see nothing steep enough to suggest anything like a V-shaped recovery,” he said.



www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>