

Gary Shilling's Version of the New Normal

By Robert Huebscher

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A dramatic reduction in consumer spending has doomed the US economy to slow growth and deflation, according to Gary Shilling. America's 25-year spree of profligate spending is over, and it will be supplanted by a decade-long retrenchment that will ultimately bring the consumer savings rate from 4% to double-digits, where it has not been since the mid-1980s, he said

Shilling, who runs an eponymous Florida-based consulting and investment management firm, spoke at the Financial Advisor Symposium in Orlando on November 9.

The death of the consumer

Shilling said increased consumer savings are not reflected in current equity valuations or in the thinking of most economists. The rally that began in March, he said, "implies that something is going to happen in the economy – we are going to have a v-shaped recovery." Only a revival in consumer spending can produce the growth in earnings necessary to justify current valuations, according to Shilling.

Shilling does not share the view that robust consumer demand justifies market valuations. "I think consumers have really changed and have reached a watershed."

Backing up his claim, Shilling said consumers saved all their tax rebates in the summer of 2008 and their \$250 Social Security rebates this spring. Those rebates went to lower- and middle-income segments, reflecting a "tectonic shift" across the consumer landscape.

Shilling also presented data that will be familiar to readers of these pages, showing, for example, that the ratio of consumer debt-service payments to disposable personal income has risen steadily from just above 10% in 1980 to 14% last year but have since leveled off as increased consumer savings have been used to pay down debt.

Consumer saving has declined by a half-percent annually since the mid 1980s, meaning that spending was increasing a half-percent faster than annual income.

The cause of the consumer's death identified by Shilling was unsurprising – the crash in housing prices crippled buying power, he said, noting that one-third of all mortgages are



now underwater. The poor performance of US equities over the last decade further impeded spending, leaving consumers with few assets against which to borrow.

“People have an awful lot of pressure to save because they have run out of sources of borrowing,” Shilling said, noting that the decision to cut back on spending was not voluntary.

Demographics are working against increases in consumer spending. Shilling said that the largest segment of the population – the postwar baby boom generation – are nearing retirement and will be more frugal, while those in their 20s, who are more likely to spend, make up a smaller part of the population.

Money saved by consumers has gone to pay off mortgages and consumer loans. He said consumers are also saving on housing; new construction has been slow, yet vacancy rates are rising, indicating that many people are moving in with their parents or seeking other ways to avoid or delay housing purchases.

Unemployment numbers are misleading

“The reported statistics on unemployment, which just reached 10.2%, do not tell the whole story,” Shilling said.

For the first time since the 1930s, two factors – voluntary furloughs and wage cuts – are exacerbating the unemployment crisis. Deflation over the last six months has forced companies to use those two measures to cut costs.

The mean duration of unemployment increased from 16 to 26 weeks during this recession, he said, further depressing consumer demand.

Meanwhile, Shilling said, corporate profits have been strong over the last decade. “Corporations have done very well by not hiring” and have benefited from tremendous increases in productivity, he said.

But that era of strong corporate performance has ended, Shilling said – it died along with the US consumer.

Expect another stimulus package

Of the recent \$787 billion stimulus package, Shilling said, “only \$200 billion went to rock-hard stimulus spending” like infrastructure and unemployment. “The rest was for the administration’s social agenda.” He cautioned to prepare for another stimulus package focused on job creation.



“We know that tax cuts don’t work,” he said. “Maybe job creation and infrastructure will.”

Such a stimulus might break the cycle of unemployment and depressed consumer demand and “get us out of the recession – maybe by the middle of next year.”

Shilling is not convinced the current recession is over. He noted that in eight of the 11 postwar recessions there was at least one quarter of positive GDP growth, as was reported in the third quarter of this year.

Shilling’s version of the New Normal: Slow growth and deflation

Two factors – consumer retrenchment and inflated housing inventories – will contribute to delaying economic recovery, which will begin slowly in mid-2010, according to Shilling.

A million additional housing units – over and above typical inventory levels – will prevent a rapid housing market recovery, he said. Housing normally recovers before a recession ends, but Shilling said that will not be the case in the current cycle.

Shilling projected growth in consumer spending of 1.4% annually over the next decade, much slower than the 3.8% average rate that prevailed from the early 1980s until the onset of the financial crisis. “That’s what it will take to bring consumer spending back to 62% of GDP,” he said.

Reducing consumer spending from a half-percent above income to one percent below income will reduce GDP growth by the difference – 1.5%. That translates to projected GDP growth just above 2%, he said.

Historically, 3.3% GDP growth has been necessary to maintain full employment, and Shilling’s 2% forecast implies unemployment could rise to 23% over the next decade in the absence of any countervailing policies. But “no administration would allow that to happen,” he said, and the new stimulus package he forecasts is one such step he expects the government will take.

I asked Shilling at what point he expects unemployment to peak. He said 11%, but did not offer any timetable.

Shilling listed a number of other factors that will contribute to a slow recovery and depressed GDP growth over the next decade: continued deleveraging in the financial sector, depressed commodity prices, increased government regulation, rising protectionism, and deflation.



Deflation has been a consistent theme in Shilling's forecasts for the many years, and he said it will cause consumers to delay discretionary purchases. Increased labor supply, excess industrial capacity, and reduced consumer demand have combined to produce deflation, which Shilling said still prevails in the US economy.

Shilling forecast 2% to 3% deflation in the major CPI indices, although he did not say how long it would persist.

Monetary policy has been ineffective in combating deflation, he said, because "credit-worthy companies do not need to borrow and, for others, the banks are not willing to lend."

Quantitative easing and huge deficits will not be inflationary, according to Shilling. He does not expect the administration to implement any policies intended to stimulate bank lending. Even if inflationary signs arise, Shilling believes the Fed will quickly react by tightening monetary policy to arrest inflation.

I believe the most vulnerable aspect of Shilling's thesis is his forecast of long-term deflation. Historically, as Bruce Greenwald noted in his recent [interview](#), inflation requires inflationary expectations and wage pressures. It also requires higher industrial capacity utilization. But there is no guarantee that those historical precedents will govern in the current environment, because that history does not include periods of extreme federal budget deficits that many forecast. Shilling minimizes the possibility that budget deficits will push interest rates unexpectedly and abruptly higher and, with that, inflation will be more of a threat than it is currently.

Implications for investors

If you believe Shilling's forecast of slow growth and deflation, then you should avoid the following types of investments:

1. Industries dependent on big-ticket consumer discretionary spending (e.g., automobiles, appliances, and travel). These expenditures are too easily delayed in a deflationary environment.
2. Companies with below-average revenue growth, high fixed costs, and large amounts of debt. These companies have less flexibility to raise prices, and the cost of servicing their debt increases with deflation.
3. "Old technology" companies that manufacture capital equipment. Capital equipment spending will be depressed until capacity utilization increases.
4. Art and collectibles. These rise with inflation and suffer with deflation.
5. Banks and financial institutions. They will be hurt by continued deleveraging and by a flattening of the yield curve as short-term rates eventually increase.
6. Consumer finance-based companies. Consumers will use less credit, and delinquencies and defaults will increase.



7. Junk bonds. Spreads in this sector no longer compensate investors for the risk of default.
8. Conventional home builders. They will suffer until the excess housing inventory is absorbed.
9. Commercial real estate. This sector suffers from overcapacity, particularly in hotels and shopping malls.
10. Commodities. Commodity prices will remain depressed under deflation, and Shilling said commodities do not command status as an asset class.

Shilling identified nine areas as buy candidates:

1. Dividend-paying stocks. With 2% projected real GDP growth and 2% deflation, Shilling forecasts no nominal GDP growth. Since corporate profits historically correlate with nominal GDP growth, Shilling expects the bulk of equity returns to be in dividends rather than capital gains.
2. High-quality bonds, especially Treasury bonds. Shilling forecasts 30-year rates to decline from 4.3% to 3%.
3. The dollar. The dollar's decline will end as its importance as a safe haven increases.
4. North American energy. The US and Canadian energy industries will benefit from political stability relative to other parts of the world and from renewable energy policy initiatives.
5. Consumer staples and food. Deflation and slow growth will not impede consumer purchases of necessities, such as toothpaste.
6. Investment advice and asset management. Growth will come because consumers need help with financial advice, provided that fees are commensurate with the value provided.
7. Factory-built housing and rental apartments. These sectors will benefit as consumers no longer think of housing as an investment.
8. Healthcare. This will benefit from Obama's initiatives and from its ability to employ people with diverse skills and backgrounds.
9. Productivity enhancers. Without inflation pushing up revenues, reducing costs is the way companies will improve profits.

Shilling did not say whether he believed industries in the above sectors were over- or undervalued, only that their growth rates would diverge from historical averages.

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