

Gary Shilling: America's Lost Decade

By Robert Huebscher

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The US faces 10 years of slow growth and deflation that could rival Japan's "lost decade" – two words which Gary Shilling did not utter but which unmistakably characterize his forecast.

Shilling laid out his deflationary forecast along with his investment recommendations at last week's Strategic Investment Conference, held in San Diego and hosted by Altergis Investments and Millennium Wave Investments.

Shilling is founder and President of the New Jersey-based economic consulting firm A. Gary Shilling & Co. His talk was titled "Investment Strategy for an Era of Slow Growth and Deflation."

Our GDP will grow by a mere 2% annually over the next decade, Shilling said, and further growth will be impossible while we "socialize our debt" – transferring financial sector and household liabilities to the federal balance sheet.

"This deleveraging, in my estimation, is going to take at least a decade, and that's the good news," he said. "If it were to happen in a couple of years, it would make the Great Depression look mild."

Deleveraging has not and will not proceed smoothly. As one crisis subsides, another will emerge, Shilling said. That sequence has so far played out in the sub-prime crisis, the Bear Stearns and Lehman failures, US consumer debt problems, and now the perilous situations in Greece and other parts of Europe.

The next crisis in this unfolding saga could come from commercial real estate, China, or Japan, Schilling speculated.

The byproducts of deleveraging are slow growth and deflation – a potent combination that Shilling said is very hard to combat. Japan has famously fought this battle for the last two decades and lost, and he expects the US will fare no better.

Deflation drivers

Over the last 25 years, the US consumer has saved less while borrowing and spending more. Consumer debt service as a percentage of after-tax income has



doubled, and consumer spending as a percentage of GDP grew from 62% to 71%, Shilling said.

Shilling calculated that higher borrowing and lower savings contributed 1% annually to GDP growth. That profligate binge will reverse and subtract 0.5% each year from GDP growth going forward, creating a net swing of 1.5% slower GDP growth. US real GDP grew 3.7% annually during the last quarter century, and that 1.5% deficit means it will grow just 2.2% per year over the next decade.

Three factors underlie this consumer retrenchment, according to Shilling. First, consumers have “run out of borrowing power,” he said, as the equity portions of their portfolios have been ravaged by two declines of 40% or more in the last decade. Only two other declines of this magnitude have occurred since 1900.

“This has shaken people’s confidence in stocks,” he said, noting that in 2009 investors pulled \$53 billion from equity mutual funds while putting \$375 billion into bond funds.

The decline in housing prices has also eroded consumer borrowing power. Shilling cited data from Yale professor Robert Shiller, which showed that, after correcting for inflation and for the tendency of houses to get bigger over time, housing prices over the last century were relatively constant until the start of the bubble at beginning of the last decade. They have not yet reverted to their historical level, and Shilling predicted a further 10% decline.

Demographics – the aging of the post-war baby boomers – is the second cause of consumer retrenchment, Shilling said. Those who are in their 20s and just beginning their working careers are the worst savers, and those in their 50s, who have finished putting their children through college, are the best. Because most baby boomers now fall in the latter category, savings rates are naturally rising. “We are going from the worst to the best demographic conditions for savings,” he said.

Third, Shilling said high unemployment will persist, further dampening demand and causing consumers to save more as they face an uncertain future.

Consumer retrenchment will combine with a number of other factors to produce slow growth and deflation, Shilling said. Continued financial deleveraging, lower commodity prices, increased government regulation, rising protectionism and a weak housing market are among the challenges our economy faces.



Monetary and fiscal policy won't work

Monetary policy will be ineffective to combat deflation. Turning the excess reserves created by the Fed into inflation would be a multi-step process, Shilling said. More economic growth must occur to spur credit-worthy borrowers and banks to do business with one another, but, for now, both are "too scared" to restart the credit cycle, he said.

Even if that restart were to happen, Shilling said it would take several years for bank loans to grow to the point where they could work their way into the money supply in sufficient volume to create inflation.

Inflation, under that scenario, could only occur if Fed officials "sat on their hands and let it run away," Shilling said. Fed bankers, though, are indoctrinated to be obsessive inflation-fighters and, according to Shilling, would never allow run-away inflation.

Economies across the globe have responded to weak private sector demand with fiscal stimuli, and Shilling expects that pattern to continue. His data show that real GDP must grow 3.3% annually to maintain stable employment, and his projected growth rate of 2.2% would cause unemployment to rise 1% annually. "No government – left, right or center – can stand for that kind of high and rising unemployment," he said. Their response will be additional stimulus spending and higher deficits.

As consumers save, they will repay their debt and, Shilling explained, the banks will invest that capital in Treasury securities, recycling the funds and keeping the money supply from growing. "This is the Japanese model," he said – fiscal stimuli go into the hands of consumers, who in turn lend that money back to the government through the purchase of government bonds.

Shilling did not address the question of whether a ballooning federal deficit could, at some point, overwhelm the capital markets and force higher interest rates if the supply of US Treasury securities outstripped demand. That scenario could lead to a weak dollar and, therefore, inflation. This, in my opinion, is a scenario investors must consider before they ascribe to a deflationary outlook like Shilling's. Whether rates rise a decade from now, as is Shilling's timetable for deflation, or much sooner will greatly affect one's asset allocation decisions.

Shilling told me the scenario with the most potential to disrupt his forecast is a surge in consumer demand and spending. That would invalidate his forecast of increased personal savings rates and make it much more difficult for the Fed to fight inflation. He is confident, though, that high unemployment makes this scenario a remote possibility.



Investment implications

Shilling offered a series of investment recommendations for those who ascribe to his deflationary forecast:

1. Treasury bonds – The 30-year Treasury bond is attractive at its present yield of 4.78%. If it were to decline to 3%, investors would earn 35%. A zero-coupon 30-year bond would return 65%.
2. Dividend-paying stocks – “Dividends will be a larger part of equity returns because of slow price appreciation,” Shilling said.
3. Consumer staples and foods – These sectors naturally benefit from slow growth.
4. Small luxuries – When people don’t have much money, they still want status from inexpensive products like the iPad.
5. The dollar – Shilling expects the dollar to trade 1:1 with the euro and to strengthen against the Yen. “Those who have tried to short yen for the last 25 years will finally make money,” he said.
6. Investment advisors and financial planners – Consumers need financial help, and advisors that charge appropriate fees will do well.
7. Factory-built housing and rental apartments – People are separating where to live from what is a great investment.
8. Selected health care providers – This sector will benefit from the passage of the health care bill, but it will be risky due to government policy interventions.
9. Productivity enhancers – Cost-cutting will be key for businesses and even low-tech firms like outsourcers will benefit.
10. North American energy producers – Shilling likes conventional energy providers, because renewable energy demand is too dependent on government subsidies.

He listed a number of investments to avoid:

1. Big-ticket consumer discretionary purchases – These purchases will be postponed because of deflationary expectations.
2. Consumer lending – Higher savings rates will translate to lower demand for credit.
3. Conventional home builders – Due to weakness in the housing market
4. Antiques and art – High-end luxury items will do poorly in an era of frugality.
5. Banks and consumer financial institutions – Increased regulation will decrease profits.



6. Junk bonds – Current prices do not properly reflect the increased risk of default.
7. Low-tech capital equipment – Businesses will postpone capital spending decisions.
8. Commercial real estate – Shilling said this is one of the most fragile sectors of the US economy.
9. Commodities – Low consumer demand will hurt commodity suppliers.
10. Developing-country stocks and bonds – They are too dependent on the US consumer.

Investors should expect a volatile and risky investment climate with subdued returns. “Prepare for more frequent and deeper cyclical bear markets and bull markets that will be less robust,” he said. “Concentrate on investments that pay cash now, like dividend-paying stocks and high-quality bonds.”

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