

## Shared Sacrifice

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The downward trend in "eating out" has broader connotations, by the way.

Now that everyone is focused like a laser beam on Fiscal Armageddon, it may be more appropriate to look at what is happening on Main Street rather than Washington. Looking ahead, it is going to be more about the economy, and taking it a step further, at times like these, it is important to understand where the real economic power resides, and this is with the people.

And not just where they shop, but where they eat, in this era of frugality.

In the meantime, it is reasonable to assume that disinflationary pressures will intensify. As the tax base gets broadened and entitlement reform takes hold, an enormous amount of shared sacrifice will be required. Less government will require a move toward tighter budgets and this will continue to stress in the job market and after-tax personal incomes, at least for a while. Attitudes are changing radically, as there is a growing acceptance among public sector unions and civil servants that the way they spend and save is going to undergo some radical changes in the future.

Furloughs, layoffs, and now less-generous pension benefits for public workers and retirees are occurring for the first time ever. Sweeping changes are taking place at the state level as pension trustees and legislatures are pushing for higher monthly contributions to pension plans, a later retirement age and lower cost-of-living adjustments for current and retired workers. Unions (those that don't make Twinkies, in any event) are making the concessions because they can see the future absent shared sacrifice – the termination of defined benefit plans in favor of defined contribution plans. Be that as it may – employee contributions are going up – a *de factor* tax hike. And this will work directly against any upturn in consumer spending when you consider that the state and local government sector employ nearly 20 million people or 15% of the national job pie.



So we will have less government, fewer entitlements, and more whisperings that it isn't just the \$250,000+ high-income households that are going to experience tax increases and diminished disposable income growth. This is shared sacrifice. To think that the nation could have ever gone to war in Iraq and Afghanistan under the Bush regime, putting our troops at great risk not to mention the emotional scars on their families, while here at home civilians would be allowed to enjoy tax cuts and a debt-financed construction binge. This is something worth contemplating as everyone joins in to redress a national balance sheet that has gone parabolic.

At all levels of the social structure, starting with households and followed by unions and governments, the US will be swept up in a sprint to frugality now that the Baby Boom has run out of time to speculate. They will be saving the old fashioned way. Everybody talks about how ultra-low long-term interest rates have nowhere to go but up – well, the same can be said about the US personal savings rate. The problem for bond bears, however, is that the likely increase in the latter will thwart any attempt for a sustained increase in the former, given the disinflationary consequences from an aggregate demand viewpoint.

The critically important Baby Boomer generation will, out of necessity, be pursuing a strategy of working longer, saving more, and liquidating debt in order to secure a comfortable retirement while at the same time the public sector moves in the very same direction toward fiscal probity. In the case of government, solvency will be restored by reducing non-essential services and severely means-testing entitlements while increasing taxes and user fees. One has to wonder what events would provide positive momentum to GDP growth, push corporate earnings to record highs as the consensus predicts as early as next year, or generate any lasting inflation, for that matter.

It's the people who make these pricing decisions. Businesses can only price up to what consumers are willing to pay. It is households who determine whether or not we have inflation, not some bureaucrat in Washington who believes he has control over some printing press. Surely the Fed's largess in this cycle would have been the proof of the pudding that when a secular credit contraction results in declining monetary velocity, inflation goes down, not up. And when the underlying trend is already below 2%, one can see that disinflationary risks are nontrivial even as Wall Street research houses are forecasting the return of a rising interest rate cycle.

This all then begs the question what it is we are all supposed to be bullish about? Especially since 0% policy rates leaves cash as little more than a tactical asset.

The answer is, from an investment stance – S.I.R.P. Safety and Income at a Reasonable Price. High-quality bonds with duration. Capital preservation strategies with low correlation to the equity market such as classic long-short hedge fund exposures. And hedges against recurring bouts of global financial, economic and geopolitical instability mean a core holding of precious metals in the portfolio. Strong balance sheets, positive net free cash flow yield, earnings stability, non-cyclical sectors and dividend growth and



yield are all the characteristics that should be screened for in any equity market investments. Credit arbitrage strategies make good sense as well given the Fed's ability to mitigate asset price volatility via its balance sheet expansion and sustained corporate balance sheet conditions. The demand-supply balance for oil is particular constructive and heightened geopolitical risk will help the basic material sector retain an allure. There are also special situations with regard to the prospect of US energy self-sufficiency, improvements in net household formation, and medical technologies. So there are still needles in the haystack for equity investors in a lingering disinflationary environment being accentuated by the looming fiscal austerity and the shared sacrifice this entails at all levels of society.

Rather than looking at the situation from the lens of a V-shaped rebound in inflation, it seems far more likely that we could well be in for a prolonged period of price stability or modest deflation. It is reasonable to assume that a resumption of strong GDP and earnings growth in the future and a resumption of inflation and appropriate inflation investment strategies will have to await the end of the rebuilding phase in the household and government balance sheets. The flip side? Cash at 0% nominal rates and negative real yields is hardly an effective way to build wealth or even preserve capital going forward. The current and prospective environment should be more focused on the preservation of cash flows as the principal means of generating total returns, until the next cycle of aggressive growth and organic global cyclical expansion takes hold.

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