

The Big Picture

By David Rosenberg

December 4, 2012

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

The following is excerpted from the November 26 edition of "Breakfast with Dave," a publication from the Canadian research firm Gluskin Sheff:



We remain in the throes of a secular era of disinflation. We are also in a long-term period of sub-par economic growth and below-average returns. That has become so well entrenched that US pension plans now have more exposure to bonds than to stocks, as we highlighted two weeks ago. Look, this is not about being bearish, bullish or agnostic. It's about being realistic and understanding that in our role as market economists, it is necessary to provide our clients with information and analysis that will help them to navigate the portfolio through these stressful times. Our crystal ball says to stick with what works in an

uncertain financial and economic climate – in other words, maintain a defensive and income-oriented investment strategy.

It is our contention that in this post-bubble, mean-reverting process, the ability for policymakers to re-create the credit cycle, relate asset values and ignite a consumer-led recovery is going to be thwarted by secular changes in attitudes toward borrowing, saving, discretionary spending and homeownership. In other words, even after enough debt is paid off, the baby boomers' spending years will be focused on putting their money in the coffee can. The first of the boomers are now turning 65 and the median boomer is now 55, going on 56. At the margin, they will now be forced to plan for retirement by setting aside an even-greater part of their paychecks as opposed to relying on the perceived level of their future net worth, which had become the norm over the past two decades as inflated asset values, first in equities and then in residential real estate, triggered unrealistic expectations of the intrinsic value and capital gains potential of their asset base – an asset base concentrated in inherently unproductive items such as the house.

The missing piece in most analysis regarding the efficacy of government policy in terms of rejuvenating a new cycle of borrowing and spending is the extent of trauma that has taken place on the household balance sheet since the housing bubble popped in 2006 and the equity bull market reversed course in 2007. We estimate that the cumulative loss of household net worth, even with the recovery in recent years, is \$4.7 trillion. In other words, a 7% hole has been driven into the household balance sheet over a five-year span, which has not happened since the 1930s. Household net worth is no higher today than it was in 2006, and this realization is only now setting in.



The process of a secular rise in the US personal savings rate and the dampening effect this will have on aggregate demand will be incredibly deflationary for some time. While fiscal stimulus indeed cushioned the blow, the current reality is one of restraint, at a time when the output gap is closer to 6% - where it normally is in periods of deep recessions, not year-four of an expansion.

From a top-down perspective, what drives inflation is the shape and interaction of two different curves – the economy’s aggregate supply curve and the aggregate demand curve. The movements in these curves tell us where the “output gap” is at any moment in time – the “gap” between where the economy is actually operating and the level it would be operating at if it were running flat out at full employment. In other words, the “gap” measures the degree of slack in the labor and product markets, and this “gap” at 6% currently augurs for “fair-value” or “equilibrium” policy rates to be -2.4% according to our research, which is why at the zero bound, the Fed has been and will continue to focus on non-conventional measures aimed at lowering the cost-of-capital.

Against this backdrop, we continue to advocate a relatively high fixed-income orientation in the portfolio – a focus on S.I.R.P. (safety and income at a reasonable price). That includes high-quality corporates (and chose those with strong balance sheets, high cash reserves and minimal refinancing needs), cross-over credits and credit arbitrage strategies. And in the equity market, continue to screen for dividend yield and consistent organic dividend growth in non-cyclical industries.

www.advisorperspectives.com

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