February 2009

"Deleveraging the Consumer"

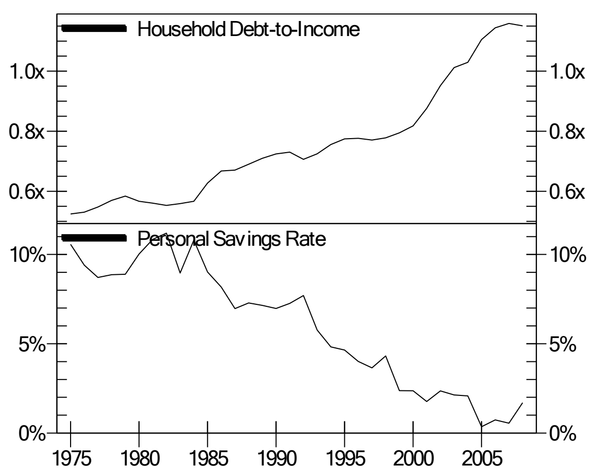
DAVIS HAMILTON JACKSON & ASSOCIATES

In the November 2008 letter, "100 Years Ago," I compared the financial panic of 2008 with that of 1907-1908. I tried to argue that financial panics are nothing new, and this one was likely over. I pointed out, however, that the economic consequences were just beginning.

So far, this appears to have been an accurate assessment. The markets have quieted down, volatility and liquidity premiums have fallen, and corporate bond spreads have stabilized. Likewise, the deterioration in economic fundamentals has been remarkable. Since November, earnings estimates for the S&P 500 Index have fallen 23%, the largest 12 week decline since First Call began calculating the data.

One of the issues I mentioned in the November letter was the condition of the consumer's balance sheet and the role that it would play in prolonging the economic downturn. Between 1980 and 2008, the domestic consumer went on a tremendous shopping spree. This spending was financed primarily by saving less and borrowing more. As shown in the chart below, the domestic savings rate fell from 11% to roughly 1%, while debt levels (as measured by household debt as a percent of income) rose from 55% to 115% over this 20 year period.

The Consumer's Balance Sheet



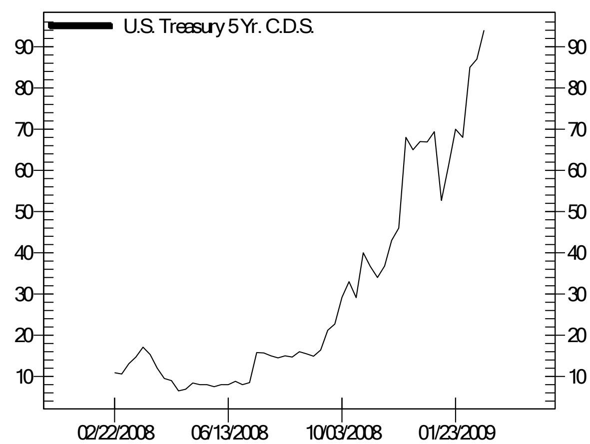
Sources: Federal Reserve, DHJA Research

These trends have put an aging population with insufficient funds for retirement in a rather precarious position. Over the next decade, consumption patterns will likely fall and savings rates will have to rise as the domestic consumer tries to restore his or her balance sheet. To the extent consumption is roughly 70% of our economy, this will cause a noticeable drag on the headline growth rate of GDP.

Domestic corporations, particularly in the financial sector, exhibited similar trends in debt levels over the same period. At its heart, the root of the financial panic of 2008 was excessive leverage. The government's response was to move the excess debt from the corporate sector to the public sector. Similarly, the government is responding to the economic consequences of the crisis by attempting to move excessive leverage on the consumer's balance sheet to that of Uncle Sam.

The risk now becomes the impact of that much debt on the federal balance sheet. The chart below shows 5-year credit default swap on U.S. Treasuries. It can be thought of as the price to insure an investor's holdings of 5-year Treasury notes against default. Until 2008, it was effectively zero as academics and practitioners alike always considered U.S. Treasuries as 'risk free'. As you can see in the chart, however, that is no longer the case. With the announcement of each new government program designed to backstop, bailout, or stimulate part of the economy, investors have grown increasingly nervous about the future solvency of the U.S. Treasury.

U.S. Treasury Default Swap Rate



Sources: Bloomberg, DHJA Research

This is not to suggest that the federal government will default in the next five years, but rather to illustrate that there are limits on how much debt can be transferred from the private to the public sector. Consequently, there is no quick fix for the consumer's balance sheet. The process of deleveraging can only be done over time. Unfortunately, this implies that it will take several years before domestic economic activity returns to a healthy level. Fortunately, however, much of this has already been factored in to current market prices. Remaining adjustments will be largely felt in the real economy.

John A. Lohman, CFA
Portfolio Manager, Quantitative Strategist
February 24, 2009