

The 3-D Hurricane and the New Normal*

Jason Hsu
Chief Investment Officer
Research Affiliates

Debt, deficit, and demographics—the 3-D hurricane—is heading to the shores of all developed economies. It threatens to derail the lukewarm economic recovery and to alter forever the heretofore path of robust growth for the developed world. In a sense, debt, deficit, and demographics will reset the world to a “New Normal”—an extended period of lower economic and return expectations for the aging and debt-ridden developed world.¹ In contrast, emerging economies with healthy government and household balance sheets, responsible fiscal policies, and young labor forces will be the drivers for global growth and will compete with their developed counterparts for economic and political leadership. More importantly, the emerging economies will demand their fair share in the consumption of resources and goods. That competition for resources and goods will lead to higher prices at a time when developed countries are less able to further finance their consumption.

Finance plays a critical role in the real economy, though only an intermediation activity. Shocks to financing for the developed economies—whether through high interest rates due to poor sovereign credit risk or through the crowding out effect from govern-

ment deficit financing—would have long-term effects on economic growth and the unemployment rate. By comparison, emerging countries have low debt-to-GDP ratios. Specifically, the Asian EM countries generally maintain trade surpluses and, therefore, also act as suppliers of global capital to the debt-laden developed economies. These healthier balance sheets, over time, mean that emerging economies would represent lower credit risk than many of their developed counterparts.

The trend of declining credit spread for EM debt has been occurring for many years. In the New Normal, emerging countries will not only converge with the developed countries, but in fact are likely to overtake many of them in short order. From the credit spread for developed sovereign debt versus emerging sovereign debt, capital markets may not have fully comprehended this pending reversal of fortune between the developed and developing economies. Emerging economies currently are assessed higher credit spreads versus developed economies, although they often have significantly better underlying collateral quality and debt capacity. This reflects an irrational bias on the part of investors; it is not unfathomable that a re-pricing of developed market sovereign credit risk is forthcoming for even the most stalwart of the developed economies—Germany and the United States.

*This article builds on presentations and discussions at the 2011 Research Affiliates Advisory Panel. I would like to thank the speakers and attendees at that event for their insight and observations.

¹See Mohamed A. El-Erian, “A New Normal,” May 2009, *PIMCO Economic Outlook*, <http://www.pimco.com/EN/Insights/Pages/Secular%20Outlook%20May%202009%20El-Erian.aspx>

When Deficit becomes Odious Debt

The extensive literature exploring the effects of deficit-driven stimulus programs provides strong evidence that short-term growth, financed by deficit spending, rarely translates into sustained long-term growth.² The argument is that government-directed investments are often zero or even negative net present value (NPV) projects—that is, they tend to be suboptimal investments. From that perspective, government stimulus programs are more about creating make-work jobs than investing in infrastructure and education that will drive future growth. The short-term increase in economic activity does not translate into future increases in production of valuable goods and services.

In a true Keynesian sense, government recessionary expenditure aims purely to smooth temporary shocks; it cannot substitute for private sector investments which are necessary to drive long-term growth. Insofar that the government stimulus is financed by more debt, it necessarily translates into higher future tax burdens, which then drains future private sector consumption and investments. By backward induction, a higher future tax burden decreases expected (after-tax) return on investments, which then reduces private sector investments today. Crowding out future and current private sector activities by the public sector growth today bodes ominously for future growth.

Indeed, under standard economic theory, the government either borrows to invest for future growth, and therefore drive future tax revenue, or it borrows to shift future consumption to the present in an attempt to ameliorate shocks to the economy. In reality, deficits have a

tendency to become ever-increasing debt. We have been all too willing to believe the story that future growth driven by indomitable American ingenuity will deliver us from our debt. Unfortunately, unless another decade-long period of explosive technology innovation is in the cards for us, we may have just now hit a wall: The debt-to-GDP ratios for many developed countries have become untenable; additional borrowing capacity is small.

In hindsight, the policy of persistent deficit spending seems utterly irrational and short-sighted. On the other hand, one might argue that this outcome is exactly rational in the context of baby boom demographics prevalent in the developed countries. Deficit spending gives an instant and immediate boost to GDP, which can feel like prosperity and good government stewardship. The natural conflict between the future non-taxpayers and the future taxpayers means that Boomers, who have controlled the elections and politics, have rationally chosen a path of more consumption today at the expense of the future generations. Whether deficit spending truly has any significant impact on subsequent growth is rather irrelevant to the discussion; voters and politicians alike would simply misinterpret the economic literature and assume more consumption today will drive more growth tomorrow. In other words, and as scientific as one can put it—the Boomers have screwed Generation X.

Democracy is one of the great equalizers for income inequality in the cross-section of population. The poor have a mechanism to instigate wealth transfers by voting for welfare and public goods production and to avoid exploitation by voting for pro-labor regulations. Democracy seems to serve quite the opposite role, however, when it comes to equalizing the inequality between generational cohorts. There is no doubt that our future generations have become extremely poor; they are each responsible for tens of thousands of dollars in national

²See a review article by John Cochrane for a survey of the literature and for references to related research. “Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies?” University of Chicago Booth School of Business, February 27 2009, <http://faculty.chicagobooth.edu/john.cochrane/research/Papers/fiscal2.htm>

debt—in some countries, Gen Xers are staring at outright national bankruptcy. But today, our political process continues to allow the Boomers to pile on new debt for the next generation in order to fund their current consumption and future retirement. It appears that democracy has facilitated the exploitation of our future poor by the current rich and indeed has been a strong contributor to what will become the Boomer's legacy of odious debt.

The great deleveraging, which has been proposed as the only responsible course of action for the developed countries after the global financial crisis, never materialized and calls for fiscal austerity have largely fallen on deaf ears. The Boomers around the world have written into law rich benefits for themselves, which have to be financed by tax dollars from future generations. Adding insult to injury, they have also pre-spent future tax revenues through massive deficit spending today. The combined weight of the explicit debt and implicit government-guaranteed obligations (such as state pensions and healthcare benefits) has begun to stress most of the developed economies and is already crushing some.

Does Monetary Policy help?

Mounting debts—whether implicit or explicit—are a long-term issue that Boomers are passing to the next generation. In the shorter term, the recent U.S. government monetary intervention (namely, QE2) has drawn many people's attention. What, exactly, has QE2 accomplished?

Although many equate quantitative easing with the printing of money, it is not entirely accurate or useful to do so. The Fed bought long-term Treasury securities from banks and issued interest-bearing reserves in return. When reserves pay interest, they are no different than T-bills; both are short-term government securities paying similar interest rates. The appropriate

way to think about QE2 is to recognize that the U.S. government simply refinanced its long-term bonds with short-term bills. If not for all the media hoopla, it has been an otherwise rather unspectacular shift in financing arrangement. No money was printed in the sense that the monetary base did not expand. Arguably, liquidity in the marketplace did not improve materially as banks do not appear to have reduced their government debt holdings in favor of other investments.

Perhaps QE2 has had an impact on interest rates. The evidence here is rather mixed. There is some weak evidence that long rates moved higher due to increased inflation expectations, while other evidence suggests that Treasury yields experienced only a brief and temporary shock before recovering back to their old trend.

Some market pundits have observed various indicators of increased speculation in the financial markets (mostly from increases in speculative positions reported by commodities traders). They argue that the large excess reserve balances held by the banks allowed banks and their related investment arms to engage in greater risk taking. The theory is that banks used their low-yielding reserves as collateral to engage in financial speculation (instead of making loans). As a result, these speculative activities seem to have resulted in higher commodity and stock prices. Whether this theory tests out or not, we do nonetheless observe ample evidence of Federal Reserve Chairman Ben S. Bernanke taking credit for the strong stock market performance as a result of the Fed's easing policy.

The wisdom of the Fed attempting to create prosperity by stimulating the stock market is debatable. Clearly, such effects can only be transient as prices ultimately are related to the underlying fundamentals. We also note that higher prices today benefit current shareholders but

result in low forward-looking returns for future shareholders. In that context, one might argue the attempt to influence asset prices is no different than a wealth transfer from the future generation to the current generation. Alarming, it appears that our fiscal and monetary policies are both geared toward exploiting our heirs.

The Prospects for Inflation

Certainly such a massive monetary intervention by the Fed has to have some impact on future inflation, right? While it seems convenient to speak in abstract terms and conclude with undue authority that the Fed is printing money and therefore creating inflation down the horizon, the relationship between Fed activities and inflation is perhaps more tenuous than one suspects.

Ultimately, inflation is too much “nominal purchasing power” chasing too few “goods and services.” Imagine that we have a large increase to our nominal disposable wealth, which increases our desire to consume, but yet there has been no increase to actual goods and services produced—*this creates inflation*. The Fed does not have the lever for increasing nominal purchasing power for the average firm and consumer. A helicopter raining \$100 bills is simply not a monetary tool in the modern central banking toolshed. Indeed, upon reflection, it should be clear that raining down \$100 bills on a selected zip code is more similar to the proverbial Roosevelt hole digging/filling program. The resulting inflation is fiscal in nature, rather than monetary. Helicopter Ben would have to run the White House, not the Fed, if he wishes to experiment on a policy of paying people with non-interest-bearing government debt in exchange for make-work labor to temporarily boost aggregate consumption. There is no doubt that inflation will ensue, but it also comes with an increase in government debt and distortions in the incentive to provide labor.

Yes, the Fed does have a printing press, but this mythical printing press simply produces non-interest-bearing government debt, which the government would happily exchange for its interest-bearing debt. The problem is that most of us aren't too interested in that trade. Bernanke can print dollar bills all day and all night (at least until we hit the congressionally imposed debt ceiling), but the Fed open market operation only allows him to trade paper bills for reserves and reserves for Treasury securities. (Occasionally, the Fed buys other securities to enact a temporary bailout; I will ignore this complication here.) At the end of the day, unless the government issues more debt to fund more spending, the Fed is just helping Uncle Sam refinance its long debt with short debt, or vice versa. It isn't clear how that has an impact on inflation or anything else for that matter, unless interest rates are manipulated so much as a result that they spur or choke off economic activities.

The more substantive driver of inflation is fiscal, not monetary, policy. The forecasted low future real growth and low future government surpluses are synonymous with a prediction of low future production of goods and services. The “New Normal” assumes poor returns to government deficit spending. The stimulus being put to work today (through deficit spending) is predicted to deliver little future output. This phenomenon then leads to high prices (inflation) as nominal prosperity created through increased government outlays cannot be converted, in the future, into increased consumption. The economy, upon recognizing the likelihood of future inflation, will respond with inflation today. This impending fiscal-driven inflation cannot be stopped by the Fed through monetary maneuvers.

Changing Demographics

As the country prepares for retiring Boomers (and the debt and deficits associated with them), it will also need to prepare for changing demographics—specifically, the adverse effects driven by the dramatic decline in the support ratio associated with an aging population. It is projected that the support ratio in developed countries will decline from 3.5 working age adults per retiree to below 2:1 by 2050. In comparison, in 1970, the support ratio was 5.3:1. By 2025, at the height of Boomer retirement cycle in the United States, there will be 10 new retirees for each new entrant into the workforce. Not only does the future appear unenviably poor in aggregate, it also appears predictably unproductive.

People consume goods and services which are produced by workers. A sharp decline in the United States and developed country workforce means that Americans, and their European and Japanese counterparts, must either reduce consumption drastically or increase reliance on imports from emerging countries. Thus, the trade deficit between developed countries and the emerging countries must continue to widen aggressively or the standard of living for developed countries must decline precipitously. However, the only way for most developed countries to maintain (and increase) their trade deficit against the emerging countries is to borrow heavily from the emerging countries. If the PIIGS are any indication of what is to come, the balance sheet, and ultimately the credit rating, of the developed economies simply would not allow further aggressive borrowing.

Historically, demographic shifts have had little impact on markets. However, the analysis could change dramatically at debt-to-GDP ratios above 100%, which is a phenomenon not seen in history. The linkage between demographics and debt cannot be overempha-

sized. Demographic shifts are generally considered to be non-risk events, in that they can be fully anticipated ahead of time. Economies with rational agents, saving, consumption, and investment decisions would allow individuals to largely manage the (adverse) effects of (unfavorable) demographic shifts. Boomers should have anticipated the untenable support ratios in their retirement. They were supposed to save aggressively during their working years (delaying pre-retirement consumption) and then convert their large and plentiful retirement assets into retirement consumption, particularly paying up for imported goods. Specifically, Boomers should have anticipated the weakening of their home currencies as their economies run greater trade deficits against the younger EM economies. Boomers should also have anticipated a significant rise in the cost of domestic services, which cannot be effectively imported from foreign labor markets.

Instead, what we observe today is inadequate retirement savings. It is long understood that the pay-as-you-go social security scheme cannot work effectively as a credible mechanism for intergenerational risk-sharing in the face of declining support ratios; as the population ages and fewer workers enter the workforce relative to workers exiting into retirement. There are insufficient numbers of young people paying into the system to support the social security payments for those who have retired. Pension schemes, or forced retirement savings, should have protected workers from the problems associated with aging demographics. Unfortunately, low contributions, high costs, and poor governance and institutional design have generally led to poor funding and adequacy ratios. The problem is further compounded by an inability to further borrow against the production of the future generation. This failure is not

due to a lack of political will and mechanism to exploit the future, but by the inconvenient reality that the future has already been fully monetized—rating agencies and international lenders are starting to be uncomfortable with the debt capacity of the developed countries. What was a predictable inevitability—the reality of an aging population—that could have been managed will become a shock that surprises economies and markets. Instead of a gradual and smooth change in rates and prices corresponding with the gradual shift in demographics, the likely outcome is a volatile and violent transition from the old equilibrium to the new.

When 3-D is Really 1-D

Deficit spending, by itself, is not particularly worrisome. That is, borrowing today to invest for the future and/or borrowing to smooth temporary consumption shocks is perfectly reasonable. The danger occurs when chronic deficit spending compounds into high debt-to-GDP ratios. Aging demographics, while a headwind against future growth, can also be thought-

fully managed. Serious problems arise when countries have become so indebted that they are unable to raise debt to bail out retirees who have, by and large, under-saved. Even high debt can be paid down if borrowed money were deployed toward investing for the future, which would result in greater innovation and productivity; technological advances can sustain future growth and consumption even in the face of a declining work force. However, if the borrowed money were largely consumed to provide current prosperity rather than invested for future prosperity, then the mounting debt will be our ugly legacy to the future generations.

The 3-D hurricane is coming. With it will come high inflation rates, high costs for credit, low growth rates, and weakening developed country currency value. Ben Bernanke in a helicopter will not stop the hurricane's devastating path. More stimulus packages will not stop it. Blaming the Chinese for lending us too much money will not stop it. Pretending that the storm isn't coming will most assuredly not stop it.

I wish I had a better weather forecast for you.

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