ORCAM ALTERNATIVE PERSPECTIVES

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The De-leveraging—Where Are We Now?

Recent economic data and market reaction has created a considerably more interesting market environment. As we head into the holiday season we expect things to become considerably less interesting...

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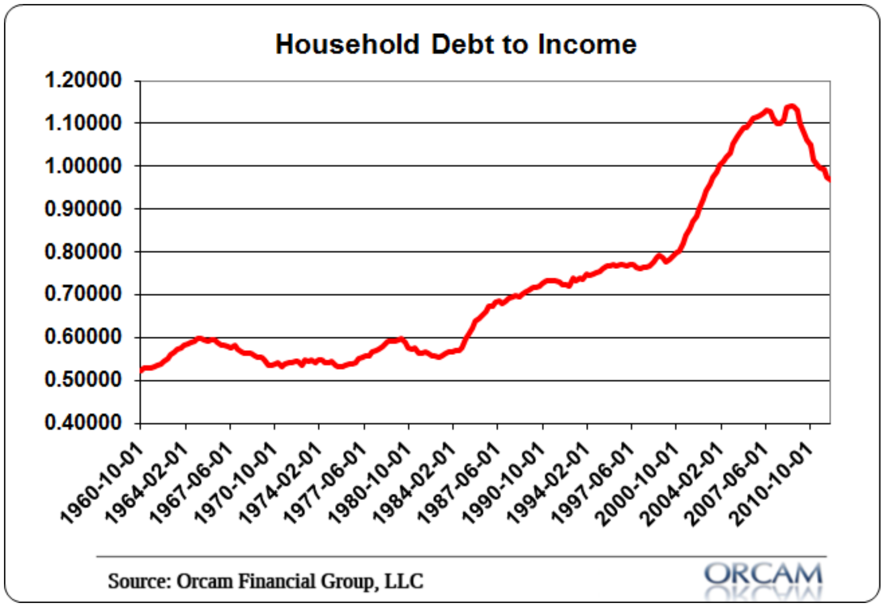
The Big Picture

There has been a great deal of news in recent weeks. Not only did the US election wrap-up, but we are also on the tail-end of the Q3 earnings season and of course the fiscal cliff still hovers over the market like a dark cloud.

The election ended as we expected and the market responded precisely how we expected, albeit a bit more quickly. Last week's ~4% decline following the election was a swift and sure sign that the market is increasingly concerned about the potential state of future government policy (regardless of who leads in that environment).

Long Story Short—We still forecast no recession, but the fiscal cliff is creating considerable risk to the downside….

The big picture remains rather tepid. The US economy remains hindered by the post-debt bubble era as de-leveraging puts downward pressure on the economy and aggregate demand. Spenders have, for all intents and purposes, turned into savers. The primary factor that has kept the US economy from turning into Greece (or Spain) with a full-blown depression has been substantial government deficits. As private investment has remained weak (as a result of weak aggregate demand) the government has been forced to pick-up the slack. We're not here to be judge and jury of such a policy approach, but the bottom line is that this has bolstered private spending by keeping incomes steady and adding to corporate profits. The market certainly understands this by now, which is what makes the fiscal cliff so potentially frightening. A $600B cut to the 2013 deficit would almost certainly send the USA back into a recession.

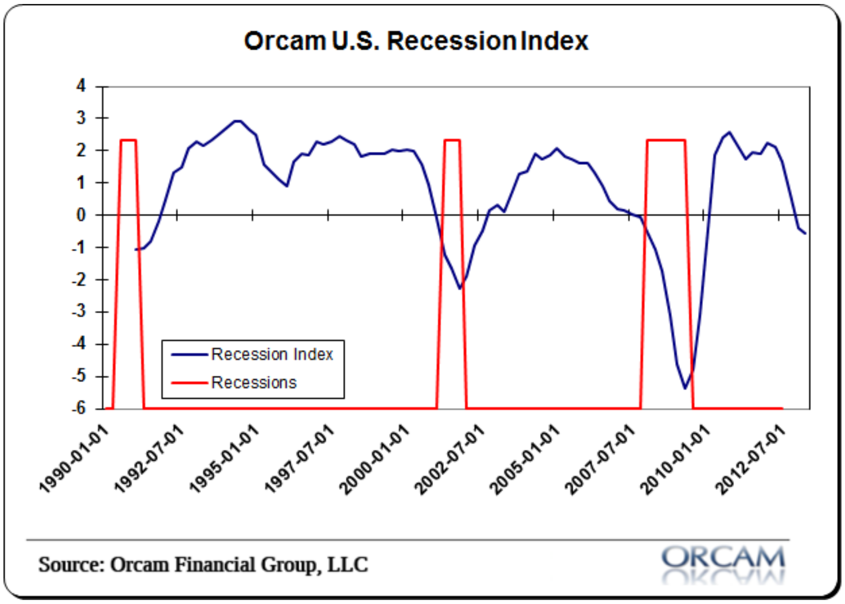


One of the key signals of private sector economic activity is borrowing. When the private sector is healthy we'll see positive trends in private investment and real estate activity as demand for credit picks-up. But as a result of the debt bubble consumers have been repairing balance sheets. This can be seen in the household debt to income ratio. At 0.96 this has normalized substantially from the highs of 1.14—levels that were unsustainable. We would expect this trend to normalize further and that the private sector will increasingly carry the economic burden as time goes on. We've seen small signs of this in recent real estate data and some other recent data, but this recovery remains extremely fragile as a result of this massively negative trend.

Recent trends imply a normalization of this ratio some time in the next 12-18 months. The current rate of change implies a ratio of 0.8 by the beginning of 2014. In other words, the private sector should be able to sustain economic growth without the massive government aid. This is a gradual process and not an event. But a substantial decline in the current government deficit would mean a reduction in private incomes which would send the aforementioned ratio headed in the wrong direction. That would be destabilizing and potentially recessionary.

For now, we're still maintaining our loose estimate for total fiscal cliff cuts in the low $100B range. There's probably some upside risk to that forecast, but if we're correct this will be far less impactful than most presume. Particularly when we consider the fact that the impact will be very gradual as tax increases won't be felt immediately.

Just for fun, we took the extreme case here and extrapolate out the full $600B in cuts in 2013. As the chart on the following page clearly shows, our Recession Index slides into full-blown recession territory by the second quarter of 2013. This would have a deeply negative impact on corporate profits, equity markets and the de-leveraging cycle. But we see this worst case scenario as being a very low probability event.



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