The Absolute Return Letter
March 2010

The Retirement Lottery

"What you as the City of London have done for financial services, we as a government intend to do for the economy as a whole."

Gordon Brown speaking at Mansion House in June 2002.

'That's too much. They'll get begging letters from Greece'

Source: Matt, Daily Telegraph

I was born in 1959, right at the tail end of the baby boom. I consider myself less fortunate than my parents, both of whom were born in 1935, when Fred Perry won at Wimbledon and President Roosevelt pushed through new social security legislation in the US as part of his so-called New Deal (some things don't die easily!).

My parents are no different from most other parents. Entirely consistent with Modigliani's life-cycle hypothesis (which I wrote about in the October 2009 Absolute Return Letter – see the link here), my parents didn't really start saving for their retirement until they reached their mid 40s. That effectively gave my father a good 20 years to ensure that he and my mum can enjoy their retirement without worrying too much about the balance between in- and outgoings.

Chart 1: Return on global equities since January 1970

Source: MSCI

My parents were lucky, because they started saving in earnest in the early 1980s, at the outset of what would become the biggest bull market of all times and, by the time the bull market came to an end in 2000, they were home and dry. In that 20 year period, a global equity portfolio generated an annualised real return of just over 13% in dollar terms, equivalent to a total inflation-adjusted return of about 850%!

Unfortunately, not everyone has been that privileged. My generation has only been saving for the last decade or so, and we are still under water. $100 invested in April 2000 is worth about $77 today in real terms. I, together with hundreds of millions of other baby boomers

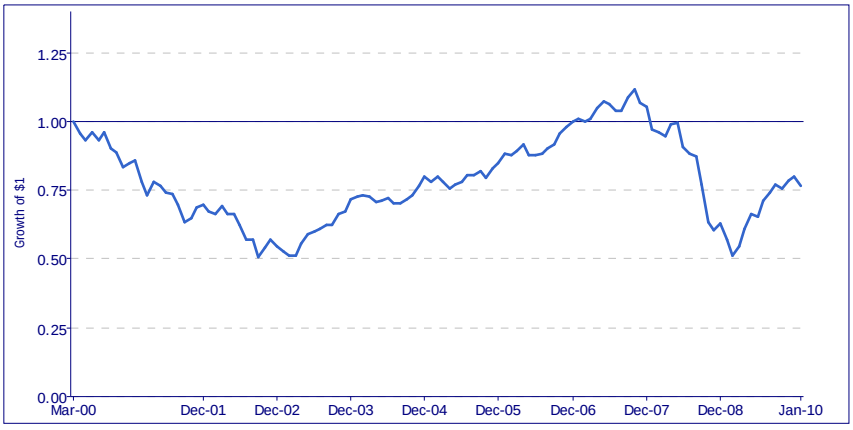
across the world, am now chasing whatever returns I can find to ensure that my retirement can be enjoyed in relative comfort. But the force is not with us. The equity market continues to be a dangerous place and the value of our property has also fallen precipitously.

What does 'long term' mean?

Meanwhile, aggressive advertising feeds us with the fallacy that, as long as you invest for the long term, equities will deliver solid returns (see chart 1 for 'evidence' of the long term positive trend in global equity markets). Yes, provided your investment horizon is 30 or 40 years, that may indeed be the case but, as I have already pointed out, most of us have only got 20 years to do the job.

However, what the sales people don't tell us is that it absolutely matters *when* you invest and *what* the rate of inflation is whilst being invested. Take a quick look at chart 2 where I have made the appropriate adjustments. Suddenly, the ten year return (since April 2000) does not look that attractive: -25% or thereabouts in real terms. Ten years is *half a life time* of investments for most people. No wonder many investors are deeply frustrated.

Chart 2: Real return on global equities since April 2000



Sources: MSCI, www.inflationdata.com

Back in 2006 I referred to a book published by Michael A. Alexander in 2000 called '*Stock Cycles: Why stocks won't beat the money markets over the next twenty years*' (see details here). Michael found that equity markets move in fairly long (secular) bull and bear markets, determined by whether the price-to-earnings (P/E) ratio[1] is rising or falling, and he argued that, over the past two centuries, we have had 14 such secular trends – 7 bull markets and 7 bear markets.

Since the publication of his work, we have entered a new secular bear trend with a general decline in P/E ratios since March 2000. I have therefore updated the charts I used in my October 2006 letter to include this latest downtrend (see charts 3a and 3b). As you can see from chart 3b, the current bear market, whilst not particularly long by historical standards (so far!), has been vicious with annual inflation-adjusted returns averaging -4.2%. For someone who has been saving for his or her retirement over the past decade, this is deeply worrying. And don't for one second think that this is a US specific problem. I am only using US data because they go back much further than European data. The phenomenon, unfortunately, is a global one.

Is the end in sight?

So where does that leave us? Is the end in sight? As you can see from chart 3b, the average duration of the seven previous secular bear

[1] *He actually used a ratio called P/R (price to resources), but P/E is a good proxy.*

markets is 13-14 years. We are only a couple of years short of the average. Is there reason to be hopeful? I believe the answer is to be found in the nature of the current recession which, by the way, is now officially over in most countries (but only officially).

Chart 3a: US P/E bull markets in last 200 years

Period	Number of Years	Real Return per Annum
1815-1835	20	9.60%
1843-1853	10	12.50%
1861-1881	20	11.50%
1896-1906	10	11.50%
1921-1929	8	24.80%
1949-1966	17	14.10%
1982-2000	18	14.80%

Chart 3b: US P/E bear markets in last 200 years

Period	Number of Years	Real Return per Annum
1802-1815	13	2.80%
1835-1843	8	-1.10%
1853-1861	8	-2.80%
1881-1896	15	3.70%
1906-1921	15	-1.90%
1929-1949	20	1.20%
1966-1982	16	-1.50%
2000-2010	11	-4.20%

Source: Michael A. Alexander

In order to understand what we are up against, over the past couple of weeks, I have spent a fair amount of time studying the works of Richard Koo, Chief Economist at Nomura. My thinking is straightforward: if anyone would understand the nature of a secular bear market, it must be the Japanese, given what they have been through over the past 20 years. Here is what I found:

The balance sheet recession

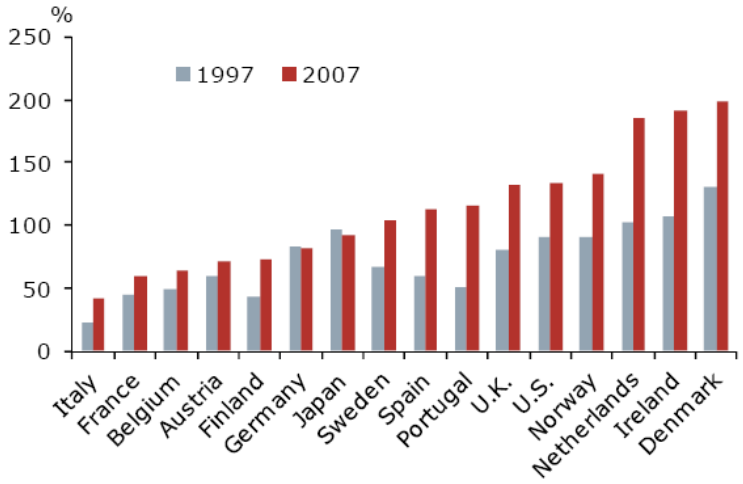
According to Richard Koo, and I would concur with that, there is one very significant difference between this and most other recessions. The typical recession is cyclical in nature. Households lose their jobs but, eventually, jobs are being created again and only limited damage has been done to household balance sheets in the process. The current recession, on the other hand, has done considerable damage to the average household balance sheet. Richard calls it a *balance sheet recession*.

When that happens, the first priority becomes to minimise debts at the cost of pretty much everything else. That again explains why interest rates can go to (almost) zero as in the case of Japan and yet nothing happens. Monetary policy becomes an altogether inefficient tool which,

by the way, implies that quantitative easing, which has been so amply used both in the US and in the UK, is actually the wrong medicine for this kind of disease.

Unlike governments who can get out of this pickle by running large deficits (or so they think), the household sector does not have that choice. Therefore, in a balance sheet recession, savings rates increase rapidly, and private consumption slumps. If you still believe this is a US, not a European problem, take a look at the following chart, kindly provided by the San Francisco Fed. I do not take any particular pride in the fact that my home country is the most indebted of them all!

Chart 4: Household leverage ratios - debt to disposable income[2]

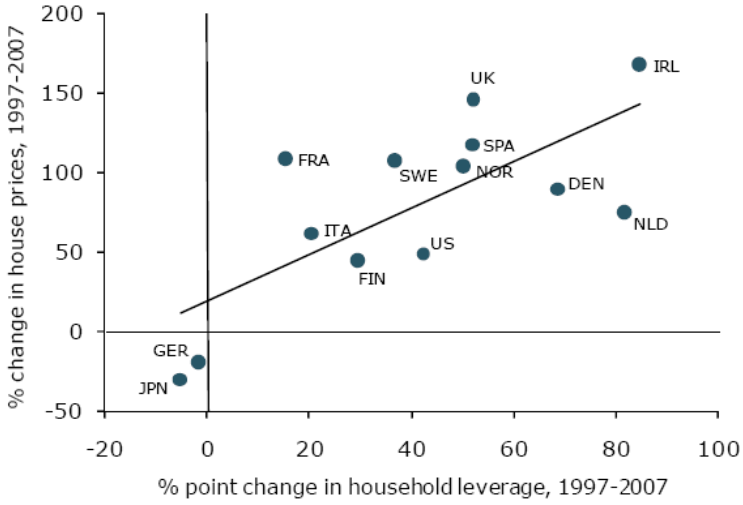


Source: FRBSF Economic Letter, 11th January, 2010.

It is the debt, Stupid!

The San Francisco Fed finds strong evidence that it was the accumulation of debt which was behind the dramatic rise in asset prices between 1997 and 2007. I have borrowed another chart from their research paper (which you can find here) in order to demonstrate this – see chart 5. As you can see, the link between easy credit and rising property prices is very much a global phenomenon.

Chart 5: Household leverage and the run-up in house prices



Source: FRBSF Economic Letter, 11th January, 2010

[2] *The following countries use different data years: Japan 1997/2006; Spain 2000/2007; Ireland 2002/2007.*

Now, with households de-leveraging in many countries (as documented by rising savings rates), there will be both a direct and an indirect effect on asset prices. Much – but not necessarily all – of the direct impact we have already seen; however, it is the indirect effect that may impact asset prices for many years to come and which I shall focus on in the rest of this letter.

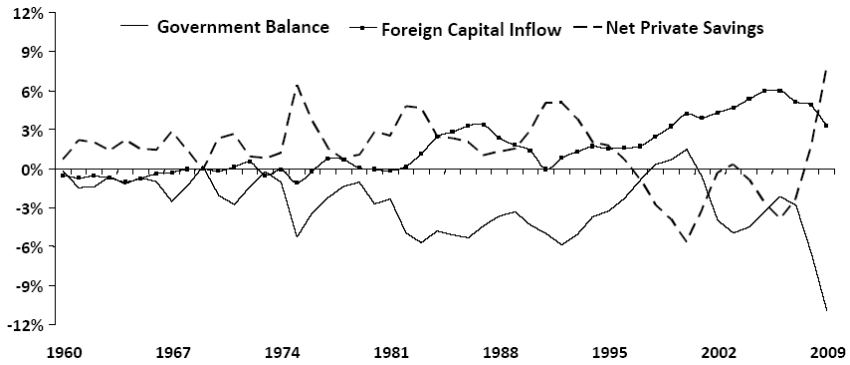
The accounting identity

In order to be able to explain the forces at work here, I need to take you back to the class room again for a minute or two. Please stay with me! Paramount to understanding what is currently going on and what is likely to happen over the next several years is the following equation, also known as the national income accounting identity:

$$\mathbf{G - T = (M - X) + (Y - T - (C + I))}$$

where G – T equals the government balance (spending less taxes), M – X is net foreign capital inflows (the mirror image of the current account deficit which is usually expressed as X – M or exports minus imports) and Y – T – (C + I) equals net private savings (national income less taxes less the sum of all private investments and consumption). Our economic adviser Woody Brock has put 50 years of US national income history together in chart 6 below.

Chart 6: The three financial balances (as a % of GDP)



Source: Woody Brock, Strategic Economic Decisions, Inc.

Every year the sum of the three parts must, and do, equal zero. *There is not other way!* The implications of this simple accounting identity are startling. Take the US economy. In 2009 the government deficit was about 11% of GDP. Net foreign capital inflows equalled about 3% and private savings totalled about 8%.

Now, if the US (or Greece or Spain or the UK or dozens of other countries for that matter) want to reduce their government deficit to a more manageable 3%, as a result of the above accounting identity, there must *either* be a huge swing in the US trade balance with the rest of the world, *or* the savings rate must collapse (or a combination of the two). As long as most Asian countries continue to get away with cheating their way to riches by keeping their foreign exchange rates at artificially low levels, a big improvement in the current account deficit is not likely to happen. And, as the experience from Japan has taught us, once you are in a balance sheet recession, savings are not likely to collapse any time soon.

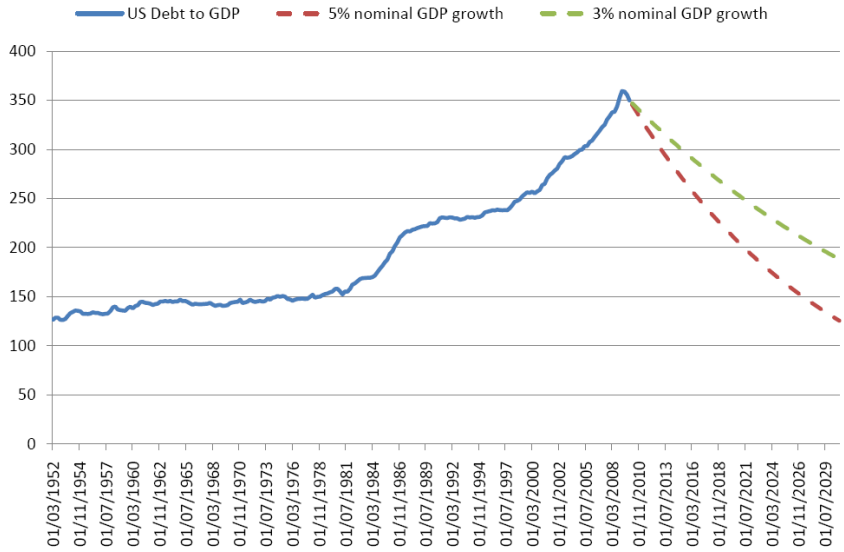
The deficit hawks need to understand what this means. Had our governments not stimulated aggressively, we would now be in the midst of the mother of all depressions. Only pupils of the Austrian school of economics would have found some satisfaction in that. In the last 100 years, we have two clear-cut cases of premature spending cuts

where the government thought it was out of the woods and cut back on its spending before the private sector had finished repairing its balance sheet. It happened in the United States back in 1937 and again in Japan in 1997. In both instances, the economy went into a tailspin.

This will run and run...

I would like to share another chart with you which landed on my desk only a couple of days ago. London based Oxburgh Partners have just released a report[3] which discusses broadly the same theme as I am discussing in this month's letter. They have calculated that, assuming nominal GDP growth can be sustained at 5% per year, it will take about 17 years for total US debt-to-GDP to return to the 150% that used to be the 'norm'. If instead US GDP grows at a perhaps more realistic 3% in nominal terms, it will take no less than 28 years to return to 150%.

Chart 7: Strong GDP growth is required to reduce debt levels



Source: Oxburgh Partners LLP

This just goes to show the magnitude of the challenge we are facing. This could be a long and painful battle against the *balance sheet recession*. As far as the US is concerned, a key danger is the ever growing income inequality between rich and poor. From 2002 to 2007, income at the top 1% of US households grew a whopping 62% compared to just 4% for the bottom 90%. The net result is that the income disparity in the US is now higher than at any time since 1928 (see chart 8)[4]. The obvious consequence of this is that consumer spending will be lower going forward, unless this trend is reversed, thereby suppressing GDP growth which is the *last* thing you want in the current situation. As pointed out by Marc Faber in his January 2010 report:

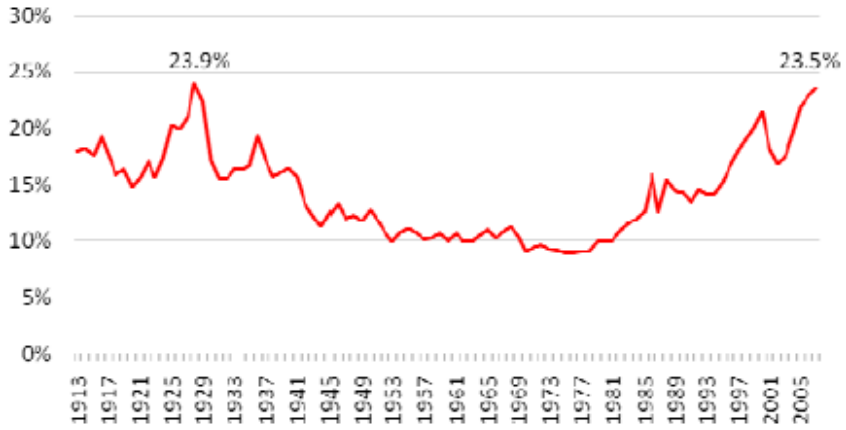
"*[...] extreme wealth disparity leads to the paradoxical situation where those at the low end of the income scale would be glad to consume but are not able to do so, while those at the high end have the ability to consume but not the desire.*"

In Europe the challenge is a different one. With private consumption in many European countries being subdued and with the euro being too strong to realistically expect that European exports can lift GDP meaningfully, Europe is facing a challenge at least as formidable as the one the Americans have to deal with. European governments may therefore be forced to accept that the only way to produce positive GDP

[3] *'From Debt-Deflation to Debt-Debasement' February 2010.*
[4] *You can read more about those statistics here.*

numbers is through continued high public spending. However, the stability pact, which governs what member states of the eurozone can and cannot do, states that government deficits must be limited to 3% of GDP. The deficit hawks in the EU will likely push for budgets to be cut at the first sign of economic growth, which could have disastrous consequences for the European economy in the medium term.

Chart 8: Share of total US pre-tax income flowing to top one percent



Source: Thomas Pikkety and Emmanuel Saez

What does it all mean?

For all the reasons mentioned above, the P/E bear market which has been running since the spring of 2000, is likely to continue for several more years. This doesn't mean that you cannot hold equities in your portfolio. There will be periods where equities do just fine. However, it does mean that a buy and hold strategy is likely to yield very disappointing returns. In next month's letter I will go into much more detail as to how I would structure a portfolio to address this challenge.

Let me round this month's letter off with one more thought from Richard Koo. One of the biggest concerns in today's environment is how and where governments will find the money to finance the continued high deficits. This is an issue that I have also discussed in a previous letter (see here). But, as Richard points out, assuming capital inflows remain constant, *"[...] the amount of money that the government has to borrow and spend to sustain GDP is exactly equal to the amount of excess savings generated within the private sector [...]"*[5]. Take another look at the national income accounting identity discussed earlier and you will see why.

I think Richard is perhaps over-simplifying matters, but he has a point. Continued high government deficits *are* likely to be accompanied by high savings rates which will go a long way in terms of addressing the funding problems so many investors are concerned about today. Whether that means that we are all too pessimistic about the outlook for interest rates, I shall discuss in next month's letter.

Niels C. Jensen

[5] *Source: http://welling.weedenco.com/files/NLPP00001/803.pdf*

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