WESTWOOD CAPITAL, LLC

MACRO OUTLOOK

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The Flight of the Doves

Money, Spending, Employment, Inflation, Disinflation, and the Need to Compete in a Changed World

Highlights

- U.S. government interventions in the economy, initially aimed at arresting financial free-fall, and swiftly followed by additional measures targeted at spurring an economic recovery, have been quite successful with regard to the former goal. But such policies have been notably unsuccessful at restarting activity that can be described as anything more than tenuous and – given recent data – perhaps temporary.

- Fed Chairman Bernanke was being quite sincere and, as subsequent events have illustrated, remarkably prescient in the short term in his view that much of the food and energy inflation experienced recently would be temporary. It is already fading.

- We believe inflation is unsustainable given opposing pressures on real (and, ultimately, nominal) wage income. Even the assurance of a perpetually bloated Fed balance sheet and the continuation of zero interest rate policy has not been enough to reflate the economy and offset the fact that what ails us is the monumental overhang of household, financial sector and public debt, which will continue to subdue demand.

- Aggregate demand destruction following financial crises is nothing new – although the dimension of the total domestic debt burden relative to GDP is unprecedented outside of Japan's. Not only did financial behavior manage to leverage the U.S. economy from some $25 trillion of outstanding debt in 2000 to over $52 trillion when the music stopped, but (i) unlike during prior debt bubbles (and unlike Japan, we might add), a very healthy portion of this economy's total debt burden, this time around, is borne directly by households; and (ii) the U.S. has been able to do nothing to materially reduce the debt burden since the wheels came off the leverage locomotive, other than to socialize a meaningful amount of private sector debt.

- The real story of today's global macroeconomics is not merely one of domestic demand collapse or the collective delusionary behavior of more-than-doubling outstanding residential mortgage debt and other household obligations against unsustainably overvalued homes. The foregoing are actually only unfortunate symptoms of a less studied phenomenon: ***The severe, and unprecedented, <u>supply-shock</u> resulting from the massive shift in the global political-economic paradigm when the full force of post-socialist, poor, emerging nations with some 3,300,000,000 people was let loose on a post-industrial, wealthy developed world of only 660,000,000.***

- The recent slowing of economic growth, from what were already subpar post-recession levels, serves to bracket the macroeconomic policy initiatives that began in late 2008 and continued for over two and one-half years. It is time to take stock of the limits of the effectiveness of such policy and to consider other options.

- In this Macro Overview we offer (on pages 11 - 13) our suggested policy initiatives to smooth and accelerate the process of resolution of the global macroeconomic picture, with our emphasis on:
  - At the very least, producing a greater percentage of what Americans consume, if not actually increasing U.S. exports.
  - Increasing savings (deleveraging) in lieu of over-consuming, to improve balance sheet strength in the household and government sectors, and to enable remaining obligations to be serviced by decreased nominal flows of funds.
  - Allowing wages to settle into real and nominal levels that make it cost effective at the margin (all factors being considered) to employ Americans.

- Recent policy has prevented developed economies of falling off a cliff, and enabled workers who are still employed to catch their collective breath. But merely not plunging off that cliff is not the same as finding a bridge across the gorge between current conditions and renewed prosperity. It is time to engage in the harder work required to build that bridge.

The Inflation Doves Were Right

It was a spectacular sight last month, at Chairman Bernanke's first press conference, as the massive cage of the inflation-doves was flung wide open and the beautiful liquidity providers flooded the sky, obscuring all other views, to the "oohs" and "aahs" of those watching from the floors of securities and commodities exchanges. The markets rallied mightily – with Fed chairman himself giving assurances that the free money policy that has kept the U.S. economy from falling back to earth again will be abandoned any time soon (except, perhaps, at the margins).

Inflation hawks, among them regional presidents Evans and Plosser, no doubt ducked to avoid being hit by the flock of continuing funding released on orders of the majority of the FOMC. But our Fed chairman earnestly shared his pain over the twin inconveniences of continued high underemployment and "temporary" food and energy inflation, perhaps emanating from a cash-bloated market facing a shortage of quality assets on which to place wagers.

But the sad truth is that Chairman Bernanke was being quite sincere and, as subsequent events have illustrated, remarkably prescient. The global economic situation has presented him with a Hobson's choice of only one alternative from his point of view. While the "inflationistas" choose to ignore the massive global imbalances that have been decades in the making, and the post-debt-bubble facts of life, Mr. Bernanke knows we are caught between the rock of sustained reliance on monetary life-support, and the hard place of becoming the victims of a tsunami of deflation. His own comprehensive academic study of the 1930's has informed him that this is no choice at all.

The "recovery," as a slew of data on the real economy since the close of Q1 (culminating in last week's employment data) has demonstrated, is quite tenuous – if not ephemeral. The sell-off on the equity and commodities markets mitigates in favor of the notion that at least a goodly portion of their previous optimism was the result of a Mississippi-river-like flood of liquidity amidst a shortage of attractive risk alternatives. The resulting extent of commodity inflation (chiefly in food and energy), even if partially related to increasing global demand, may indeed prove to be unwarranted. We believe it is unsustainable given pressures on real (and, ultimately, nominal) wage income. And even the assurance of a perpetually bloated Fed balance sheet and the continuation of zero interest rate policy has not been enough to offset the facts on the ground. Those facts have been incompatible with a growth rate sufficient to cure what ails us: the monumental overhang of household, financial sector and public debt.

The market for U.S. government and agency bonds seldom lies, because all one gets back for investing in it is principal plus, these days, a painfully small amount of interest. Bonds, of course, have rallied to an extent that a certain individual's (G)ross miscalculations about the unattractiveness of our debt seem overstated in hindsight. Real economic activity presages little demand for the excess supply of money, at least by the world's largest economy.

Chairman Bernanke deserves enormous respect for his scholarship and dedication to righting the ship, and we appreciate the unattractive options he faces. But we suspect that the lessons of the Great Depression are actually only partially applicable to the present day global economic situation. By some comparisons, we are much worse off. And despite the equity and commodities markets having gone on a liquidity-addicted bender prior to their having the bejesus scared out of them last week, it is important to appreciate why the Chairman is very much concerned. We believe that market understanding needs to go beyond the courtesy of Mr. Bernanke granting a press conference or giving a paper to show that he can communicate in something other than Fed-speak (and he has, thankfully, proven that).

Over $52 trillion of Domestic Debt

Let's not beat around the Bush: The massive debt overhang bequeathed us by the "naughties" will continue to subdue domestic demand for the foreseeable future. And debt overhangs are, as Irving Fischer and his acolytes have long demonstrated, inherently deflationary.

Aggregate demand destruction (and the possibility of "debt deflation") following financial crises is nothing new – although the dimensions of the debt burden facing the developed world demands that extraordinary attention be paid. Not only did financial behavior manage to leverage the U.S. economy from some $25 trillion of outstanding debt in 2000 to over $52 trillion when the music stopped, but

(a) unlike during prior debt bubbles, a very healthy portion of this economy's total debt burden, this time around, is borne directly by households; and

(b) the U.S. has been able to do nothing to materially reduce the debt burden since the wheels came off the leverage locomotive, other than to socialize a meaningful amount of private sector debts, by bailing out financial institutions, and monetizing government debt – the latter being the sole lever left to the Fed, in the absence of there being a political appetite for fiscal stimulus and its having discovered the zero-bound in short term interest rates.

In fact, one could even argue that the $9+ trillion of <u>government</u> debt (excluding GSE/agency liabilities and ignoring the fact that a sizable portion of the debt is held by the Fed) that congress and the media has been obsessing over, is but a minor portion of a paralyzing problem that threatens our ability to achieve growth. Typical post-recession, rapid growth, and the inflation in wages and revenues of all types that go with it, could have – if it had occurred this time around – potentially rendered even a larger debt overhang inert.

The real story of today's global macroeconomics is therefore not merely one of domestic demand collapse, although the latter is certainly a symptom of a crisis caused by greater ills. It is not even to be found in the collective delusionary behavior of more-than-doubling outstanding residential mortgage debt and other household obligations against unsustainably overvalued homes. These are homes that continue to revert in value to the *status quo ante*, while the debt burden remains.

Rather, the foregoing are actually only unfortunate symptoms of a poorly appreciated phenomenon that is at the core of both our present predicament and our own, otherwise inexplicably irrational economic behavior during the debt bubble: ***The game-changer is the severe, and unprecedented, <u>supply-shock</u> resulting from the massive shift in the global political-economic paradigm when the full force of post-socialist, poor, emerging nations with some 3,300,000,000 people was let loose on a post-industrial, wealthy developed world of only 660,000,000.***

The point here is not so much one of the magnitude, although that is very important. It is the unprecedented and entirely exogenous nature of the event.[1] The developed world's victory in the Cold War was a major geopolitical inflection point and has, since 1989, had a continuously accelerating disruptive impact on the business cycle in the developed world. To ignore this antecedent of our current crisis – or to not adequately comprehend its importance – is to miss the elephant in the room that is stomping on the wealth of nations.

Economists are, to a not insignificant extent, "historians with calculators." What is known, by practitioners of the "dismal science," is only what we are able to observe and measure from prior moments in history. Forecasts and theories emanate from past patterns – with some, more empirical, schools of economic thought actually rejecting any postulate that is not grounded in something that has occurred before. The profession is therefore not particularly well suited to the interpretation of once in a lifetime, extra-economic possibilities – often referred to as long tail or black swan events – such as floods, earthquakes, epidemics <u>or the sudden release of half the world's population from economic bondage</u>.

[1] Although, one can say with certainty that the fall of the bamboo and iron curtains was most definitely <u>not</u> extra-economic (the people behind them were nothing if not economically repressed), the end of socialism was not something that could be factored into any economic theory – cyclical or otherwise.

Supply Shock and Disinflationary Pressures

The developed world has been fully exposed for over a decade to the effects of the paradigm-altering explosion in the global supply of labor and productive capacity. We had experienced a similar event in the 1980's, on a far smaller scale, when the impact of the Japanese industrial machine began to erode U.S. jobs and living standards. But the Japanese experience was nothing more than a wakeup call in comparison to the emergence of the BRIC nations, particularly China.

In both periods, we were – for a time at least – able to camouflage with credit creation the impact of foreign and cheaper labor on our domestic economy.

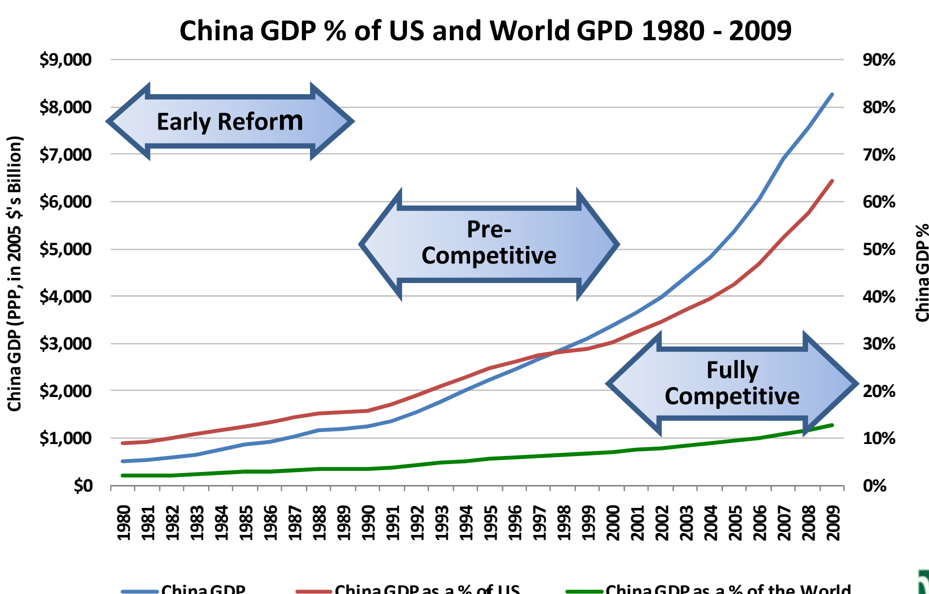
Japan itself then went down the path, on which we presently find ourselves, over 20 years ago, after the bursting of its own bubble and, we would argue (as we do below) that Japan has been forced to both deflate in order to remain competitive – initially versus the Asian Tigers – and now relative to the same forces confronting the developed world of which Japan has since become a full member.

With regard to the two decades following the collapse of the Japanese bubble, the confrontation of the other developed economies by emerging nations is a picture that was clouded for a time by two principal phenomena:

(1) The barely perceptible – but very real – process of integration of the BRIC economies into the global capitalist system during the 1990's (the need for development/improvement of plants and equipment and both internal and external transportation and communication, to say nothing of revamped political and legal systems).

(2) The very real and highly productive strides made by the U.S. economy, beginning in 1996, when we created and were chronologically the first to benefit from internet and related technologies (during which period the pain and debt overhang from the credit bubble of the 1980's was – for all intents and purposes – completely eliminated).

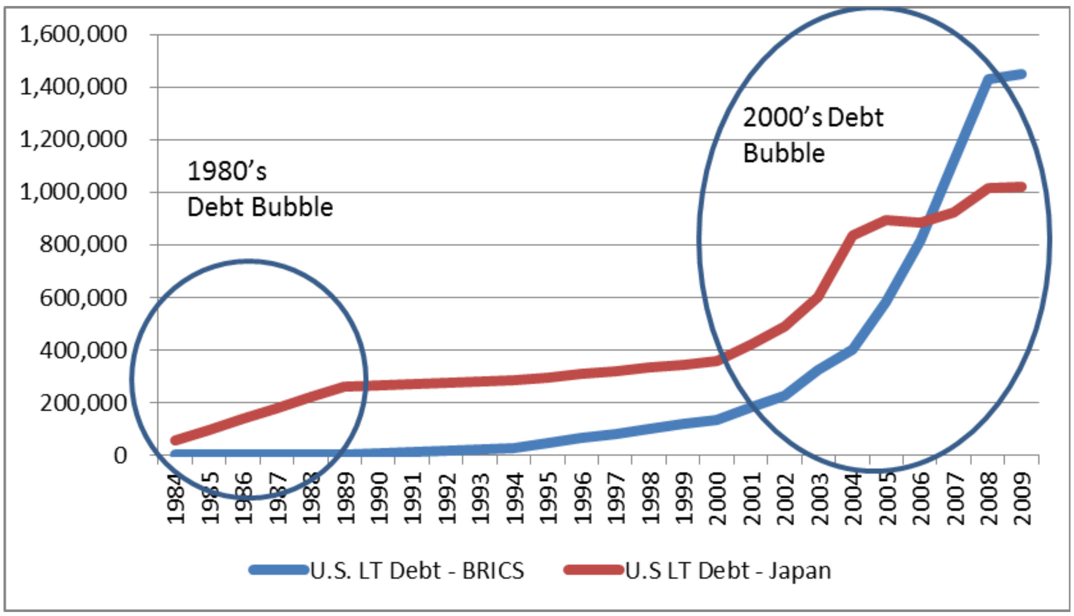
With respect to the former point, we look back on China's recent history and economic growth rates to divide the past 30 years into three periods: the pre-export model, mostly agrarian reform period of the 1980's, the organization of China's export economy and the integration thereof into the global supply and demand (and monetary) network, and, finally, the first decade of the millennia during which the full force of China and the other BRIC economies caused China's growth to skyrocket, their savings to balloon, and the enabling of the developed world's credit bubble. Note the inflection points in Chinese growth rates, in the following graph, derived from World Bank data:



What enabled the developed markets to continue to grow, against this onslaught, was the effective repatriation of fund flows in the form of official purchases of government and agency debt – nowhere more so than in the United States. The sizable imbalances in current accounts between the U.S. and the developing nations, as well as the oil exporting nations, have resulted in the accumulation of massive foreign reserves in those countries and an almost insatiable demand for higher quality investment assets. Given the massive disparities between the size of the developed economies and those of the emerging nations and, as we discuss below, the self-interest of China and the oil exporters, in particular, to sterilize inflows and assure that the export machine is protected against domestic currency appreciation, the only realistic options for investment have been and remain the financial assets of the U.S. and, to a lesser extent, the Eurozone.

As the following diagram reflects – the demand for U.S. assets from the exporting nations, and its concomitant effect on credit availability here (essentially limiting government demand for funds from domestic lenders) was the principal driver of the massive oversupply of domestic credit during both the 1980's and the 2000's:

Holdings of U.S. Long Term Debt by the BRICS and Japan
Indexed to 2009 $US

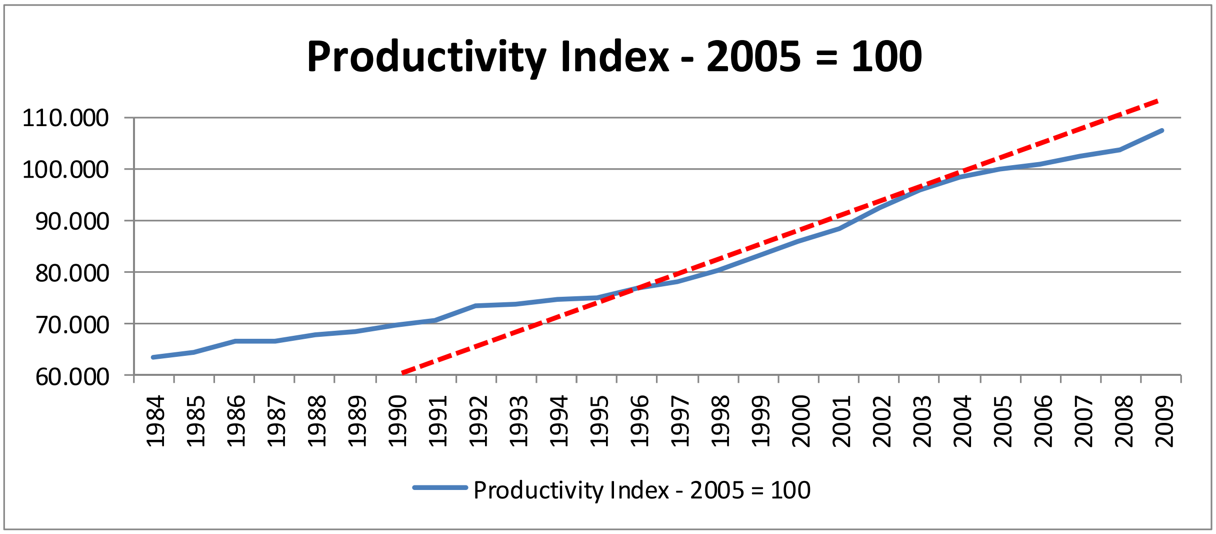


Adjusted for Inflation: U.S. Treasury and Westwood estimates - Millions of 2009 $US

The oversupply of capital stems from the continuing imbalance between the emerging and developed countries in the supply of available labor and the cost thereof. The dimensions of the current imbalances exceed – in orders of magnitude – the relatively minor challenges posed by Japan Inc. in the 80's.

With respect to the enormous boost in domestic productivity from Q2 1996 through Q3 2003, which more than held the still-nascent, emerging nations at bay until the latter stages of that period, we offer the gaph on the following page. The dashed red trend line covering the above period, illustrates the degree to which internet technology impacted the performance of the U.S. economy and the correlation between the debt bubbles, of both the 1980's and the 2000's, and more sluggish rates of productivity growth. Productivity has, of course, also grown since the onset of the Great Recession. But this has come at the cost of punishing levels of unemployment.

Eventually, however, advances in domestic productivity were overcome by the brute force of global excess labor.



Source: Bureau of Labor Statistics; Nonfarm Business Output per Hour, Series PRS85006093

Post-Crash Attempts to Induce Demand and Reflation

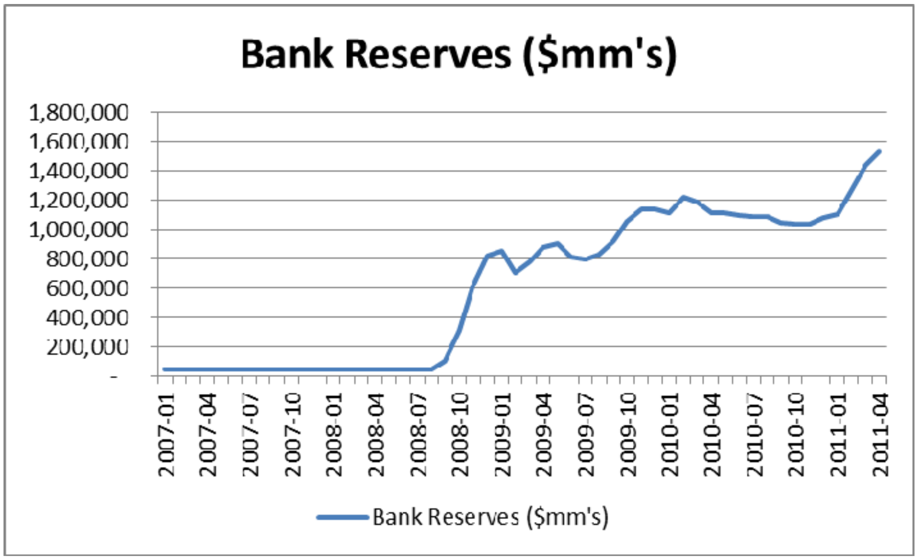
It is hard to argue Friedman's famous observation that, in times of crisis, we are all Keynesians. Fiscal (and monetary) policy imperatives aimed at inducing demand are a long-time feature of developed economies confronted with the sudden collapse thereof.

The recent slowing of economic growth, from what were already subpar post-recession levels, serves to bracket the macroeconomic policy initiatives that began in late 2008 and continued for over two and one-half years. It is time to take stock of the limits of the effectiveness of such policy and to consider other options and points of view.

Fiscal intervention, now the object of nearly obsessive scorn from many quarters, was predictably effective for as long as it lasted. That the American Recovery and Reinvestment Act of 2009 was a poorly conceived hodgepodge of $787 billion in interest group targeted (dare we say "pork barrel") spending, is beside the point, although substantially true. It is apparent that the stimulus (along with its even-more-maligned fiscal cousin, the TARP bailout of the banking and automotive industries) did not sufficiently spark economic activity to a degree, or for a long enough period of time, to increase employment, restore demand, and set us off on a sustainable recovery.

As with TARP investments in the nation's banks, the extraordinary array of monetary policy initiatives brought to bear on the financial crisis have been far less productive than conventional economic analysis postulated when they were implemented. Beginning in late 2007, the FOMC steadily reduced short term interest rates until – for all intents and purposes – policy makers came face to face with the, previously theoretical, and much-feared, zero bound.

Quantitative easing, beginning with government backed securities caught in a liquidity squeeze, and continuing today through the monetization of amounts equal to nearly all the debt issued by the U.S. Treasury since QE1 began, has created massive amounts of aimless cash looking for returns. But it is excess cash that has not sufficiently filtered through to the real economy because of a lack of credit worthy borrowers who could actually find something to do to make money from additional leverage – even with cheap money. To the contrary, it is still mostly sitting at the Fed, as illustrated on the following page.



Source: Federal Reserve Board of Governors

We observe that the lack of success of the foregoing policies stems not from the foolishness of the prescriptions. Rather its stems from the conflation of the unprecedented global macroeconomic picture, with the conventional policy one would consider appropriate in connection with a severe cyclical downturn.

Supply-side, or other more conventional, approaches to chasing consumption, may not – under current circumstances – sufficiently increase domestic production. The supply-side argument that supply drives consumption is only valid if the production of that supply is occurring within your own borders and you don't put your economy into hock driving supply.

Juicing demand through massive government-subsidized re-employment could – at least in theory – have a more beneficial near-term result (certainly from a social perspective). But we remain concerned that the magnitude of global imbalances are such that there can be little long-term benefit[2] from the original Keynesian approach without the recognition of the need to simultaneously deal with monetary, banking, consumption, savings, investment and other policies and patterns in the domestic economy, as they respect the broader set of "facts on the ground."

Of course, there is also the not-so-small issue that massive spending is currently politically unpalatable. And even if simulative spending were to again find an audience in Washington (which would, in our opinion, only be likely as the result of a true, double-dip, contraction in GDP), capital allocation decisions run the risk of being as economically inefficient as those we saw in 2009.

Why Has Recent Fiscal and Monetary Intervention Come Up Short on Success?

It stands to reason that trying to fight an over-supply with an even greater supply might not be an ideal strategy under present conditions. The same can be said, although not in a universal sense, for dealing with a debt-overhang: Adding more debt to an already over-leveraged economy is generally inadvisable, at least with respect to the private sector. The government can at least conjure currency, in lieu of borrowing – and, so far at least, has been able to get a pass from the market place.

[2] And about the only long term benefits we can see arising at this point from Great Depression style re-employment programs, in and of themselves (without coordinating monetary policy as described more fully below), would result from programs oriented around infrastructure and public works programs that materially improve national competitiveness.

Ultimately, the only cure to the economic repression and stagnation engendered by a debt bubble is to grow one's way out of it – either over time, or in shorter order with the "help" of an unrelated event such as a forced remobilization of economic assets in time of war.

But sustainable and meaningful growth, under present circumstances, is proving difficult to achieve because of developed nations' (particularly the United States') impaired ability to compete with much larger, developing counterparts – which are now pretty much full commercial rivals.

This competitive disadvantage – and the failure of recent domestic policy initiatives – stems principally from two factors: (i) the dramatic wage rate and living standard imbalances between the two blocs, and the fixed asset cost/value differentials arising from those imbalances, and (ii) the aforementioned overhang of debt amassed in the developed world.

We have previously written on how severe economic imbalances tend to work themselves out on the global stage. Throughout the knowable history of political economics, such imbalances have tended to resolve themselves through one or more of three principal transmission mechanisms:

(a) Debasement/devaluation of the unit of currency of the indebted/non-competitive country – realigning international competitiveness and permitting the repayment of debts with units of reduced purchasing power relative to certain commodities and/or other currencies;

(b) Disinflation of prices and wages in the indebted/non-competitive country – realigning international competitiveness but requiring default on, or restructuring of internal and/or external debt in order to permit that economy of the indebted/non-competitive country to resume growth and maintain social order; and

(c) Conflict between creditor and debtor nations – or conquest of emerging nations, with low cost labor and other natural resources, by established nations with higher cost structures and more limited natural resources – which conflict has historically been either preemptory action by debtor nations to avoid economic and/or political conquest (e.g. Germany in the 1930's) or action by creditor nations to reclaim what they are owed. Often, the latter chain of events is set in motion by protectionist measures put in place by the disadvantaged, but otherwise powerful debtor nation.

The present crisis, however, is playing out amidst the existence of two dysfunctional regional currency unions that severely limit the ability of the largest economies, the European Union, that U.S. and China to resolve matters using relative devaluation, as in (a) above. This is further complicated by the demonstrated impossibility, for a somewhat different set of reasons, of Japan's devaluing the yen relative to the dollar, euro and yuan, to resuscitate its economy. The binding of the countries of the Eurozone to one another, notwithstanding the disparate fiscal health of the member nations and the credit imbalances that exist between the core nations of the Eurozone and those to the south and elsewhere on the zone's periphery, in the absence of the very unlikely withdrawal of the troubled nations from the shared currency regime, will, in our opinion, likely result in the conditions set forth in (b) above.

The *de facto*, involuntary currency union between the United States and China (and the petrodollar countries, with respect to their one export) presents an even larger conundrum given the immense size of those economies, notwithstanding the fact that the E.U. is actually the world's largest.

It is fundamentally not in the interest of China, as the United States' largest trading partner and dollar denominated creditor, to accede to the deliberate devaluation of the dollar relative to the yuan. We further believe that China has the ability and desire to withstand and offset, for an extended period of time, any economic policy initiatives of the U.S. that are designed to force down the relative value of the dollar. This is not to say that beggaring the United States will not slow China's exports, as would devaluation of the dollar, but the alternative of wage and price deflation in the U.S. resulting from a continuation of Niall Ferguson's "*Chimerican*" currency union (offset by U.S.

economic growth resulting from the increased competitiveness of lower wages and prices, and the continued development of the Chinese domestic economy) is far less painful, and more drawn out, than dollar devaluation from the Chinese perspective.

As for the third transmission mechanism, let's assume for the moment that outright global conflict is not a likely solution to anyone's problems given the nature of a shrunken world in which all the major players are armed to the teeth.

Restoring Competitiveness: If It's Broke, Then Fix It

Kicking the can down the economic road is a viable way to deal with many a smaller passing crisis. Dramatic intervention and paradigmatic shifts in broad commercial and governmental relationships are tricky businesses fraught with unintended consequences. In an economy that is able to compete and grow, but is suffering from a spell of "irrational exuberance," enduring the hangover is generally preferable to major surgery. Even if an economy has slowed even substantially, but still remains reasonably competitive, a reasonable motto is "if it ain't broke, don't fix it."

But what to do if there is a possibility that one's economy is both "broke" and secularly non-competitive?

With respect to the U.S., given the ability of China, and the China-dependent and petrodollar economies, to resist the devaluation of the dollar, we think it not unlikely that – like Japan, although for slightly different reasons – America will need to become more competitive by becoming more economical in terms of real and globally-relative nominal wages and prices.

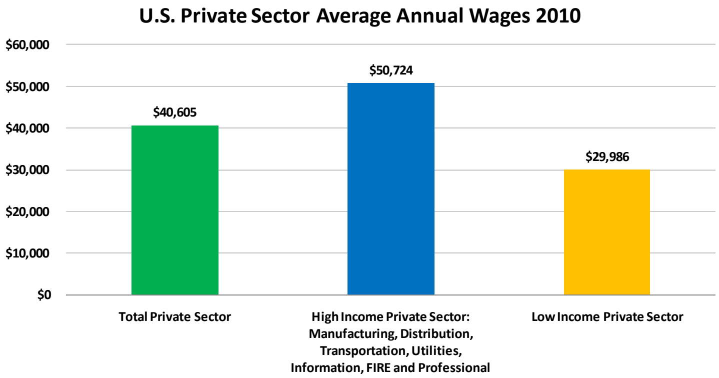
Over the longer term, developed country wages will be supported by wage inflation in the emerging markets. But keep in mind that over 650 million Chinese, 800 million Indians and hundreds of millions in other BRIC markets are still currently peasants. While short term regional reallocations of urban labor have caused upward wage pressure in coastal China – for example – the BRIC nations have such a very deep bench of excess labor and a heretofore almost untapped prospect for introducing productivity improvements. Therefore, we have difficulty believing that the wage imbalances can be resolved for the most part through wage and price inflation in the emerging markets (although improving emerging market demand and internal inflation will be an important factor).

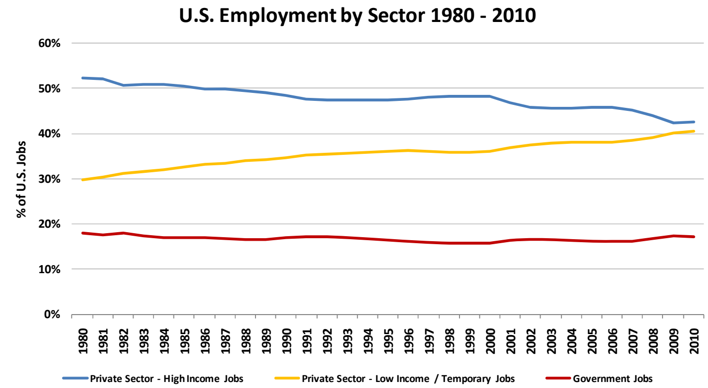
The developed nations have already endured a substantial early engagement with asset price deflation in our largest asset sector, residential and commercial real estate. The bubble in these sectors collapsed under the weight of both the debt that had been incurred to support such bubble and the inability of our production (reflected in wages) to carry the burden we had placed on the sector.

U.S. consumption, across the board, outstripped and continues to substantially exceed the production of its people. And other peoples are quite willing to plug the gap at significantly lower cost than the price and which Americans have been thus far been willing to provide their labor.

Wages, as Keynes taught, are sticky things. Prices, less so, but are not able to be sustained over any material term without wage earners being able to afford to pay them. For this reason, while wage inflation has generally always followed price inflation, the latter has never proven sustainable without the former.

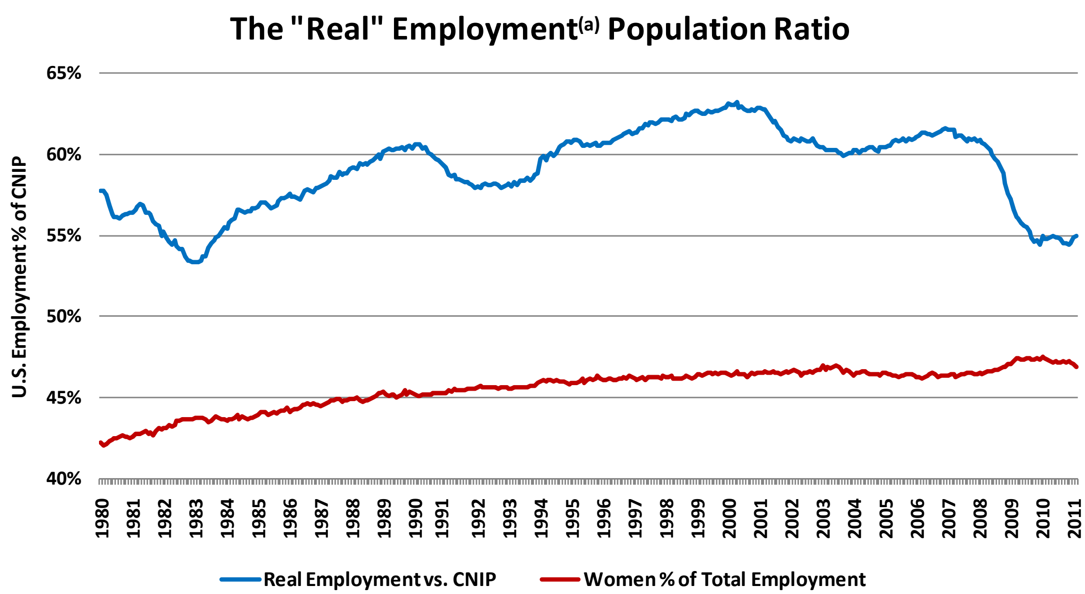
For a long while, since the "era of credit" began following the recession of the early 1980's, we have seen the steady erosion of high paying, high benefit jobs in the U.S., in favor of lower paying, lower benefit employment. Today, however, the wage gap between the higher paying jobs and those at the lower end of the spectrum is at post-war high. The following two graphs illustrate the foregoing:





Source: Bureau of Labor Statistics

The U.S. employment-population ratio (the number of people actually employed, divided by the civilian, non-institutional population – "CNIP") evidences further indication of the nation's inability to be competitive. Westwood looks at the employment population ratio after subtracting from the numerator those employed part time for economic reasons (PTER). As illustrated below, the present PTER-adjusted employment population ratio indicates that – indeed – the U.S. employment economy needs more than just a little tune-up.



Source: Bureau of Labor Statistics
(a) Total Employed minus Part Time for Economic Reasons, divided by CNIP

Note particularly that we have overlaid a line showing the percentage of women employed. So keep in mind the comparisons of today's circumstances with employment-population ratio results of thirty years ago are not entirely apples-to-apples. The U.S. enjoyed the non-wage economic benefit of millions more women in other roles, decades ago.

Some industries have been spared the direct competition from abroad. These are guild type professions, low wage service businesses and the healthcare and education sectors (which, in addition requiring geographic proximity with those serviced, have a considerable low wage component and are somewhat protected from market forces by inefficiencies. Multinational companies that are manufacturing and/or selling in the developing world have clearly shown strength, although that doesn't translate to the U.S. real economy in a way that is sufficient to restore its global competitiveness.

The business community and government both see the "innovation companies" in the U.S. as saviors, and that, rather small, slice of the economy is certainly thriving. But we do not agree with the twin views that (i) innovators represent a sufficient enough influence on an economy as large as the United States' to matter much; or (ii) American exceptional-ism with regard to innovation is a reliable long-term philosophy on which to base the world's largest economy. Creation of new technologies and products is certainly not the exclusive portfolio of either the U.S. or of the developed world in the aggregate, over the longer term.

Policy Alternatives – Nothing Worthwhile Comes Easy

Ultimately, whether via deliberate policy initiatives aimed at accelerating the process, or by letting nature take its course, the global macroeconomic picture will need to resolve itself in the following ways (from the intermediate-term point of view of the U.S. economy, in particular):

- At the very least, producing a greater percentage of what Americans consume, if not actually increasing U.S. exports.
- Increasing savings (deleveraging) in lieu of over-consuming, to improve balance sheet strength in the household and government sectors, and to enable remaining obligations to be serviced by decreased nominal flows of funds.
- Allowing wages to settle into real and nominal levels that make it cost effective at the margin (all factors being considered) to employ Americans.

Add to the forgoing the likely future increases in emerging market internal demand, relative to the global excess of labor and capacity, and the world eventually obtains a level of global equilibrium sufficient to reverse current trends.

But, in our view, the road on which the U.S. is currently travelling is one that is more likely to lead the nation down the path the Japanese have followed for two decades, than it is to achieve the type of vibrant turn-around more typical of the historical American experience. And that is not acceptable.

Thus far, we have been observing a battle between two approaches to restoring business as usual, which we fear may prove to be a fight over the number of angels able to dance on the head of a pin. Neither side, we believe, provides a sufficient answer:

1) The Keynesian approach would stimulate additional employment or have the government directly employ individuals over the medium term, but will force enduring harsh government deficits, increased national debt, some degree of subpar capital allocation and the possibility that the credit of the U.S. will be called into question by the markets, and not merely by academics, politicians and rating agencies.

2) The monetarist approach – which, for all intents and purposes, is the only remaining initiative currently being implemented – offered the hope that increased liquidity would be transmitted and multiplied to produce growth. Unfortunately, whatever growth has produced has been anemic, at best. Extraordinary monetary solutions also require that until meaningful growth is achieved we are left to endure potentially demand-destroying commodity inflation, high underemployment and pressure on the dollar that, while beneficial in the short term relative to exports, could threaten more systemic inflationary risks.

The desired outcome from both approaches, all other things being equal, would be to create sufficient domestic economic activity such that growth begets greater growth.

This has not happened and, for the reasons set forth throughout this report, is not necessarily going to have any better likelihood of success should we redouble the actions we have already pursued without sufficient result.

We believe that fighting the last war, in attacking global imbalances by attempting to stimulate demand in an overleveraged nation, is actually counterproductive at this point. Other arms must be brought to bear. Accordingly, consideration should be given to the following policy options to restore competitiveness and resume levels of employment that will produce sustainable growth[3]:

- Tax policy should be refocused away from an exclusively income taxation regime and towards a combination of a progressive consumption tax (entirely excluding certain necessities) together with the restoration of income tax levels to those that prevailed during the prosperity of the late 1990's. That additional revenues will ultimately be needed to stem deficits is clear – we've tried supply side and small-government notions for 30 years, without much lasting success, and it is past time to acknowledge that deficit reduction will need a combination of fiscal restraint and additional revenues in order to be effective.

- As continued weakness in employment is likely to exacerbate the renewed downturn in housing prices, it is time to reconsider more proactive policy alternatives aimed at ameliorating the economic disruption to what is the principal asset of most families. We have written in the past on methods of settling mortgage debt of substantially underwater households – ranging from surrendering deeds in favor of leasehold arrangements to lender-sponsored principal forgiveness that phases-in over time, with sustained regular payments. With housing prices declining anew, it is time to consider constitutionally-sustainable legislative remedies to resolve this aspect of the debt overhang.

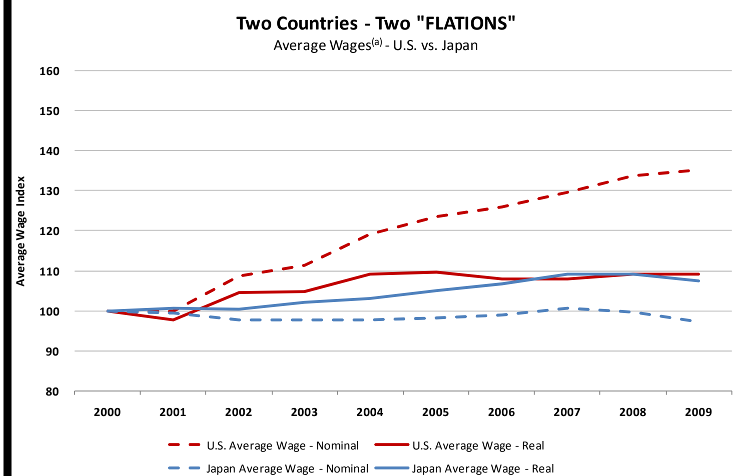
- Resolving underwater loans, however, may place the banking system at renewed risk of under-capitalization. One of the few policies advanced by U.S. bank regulators that we believe to have been completely unwarranted is the permission granted to former TARP beneficiaries to resume dividends to shareholders. Not only should this policy be rescinded, but banks should be granted formal regulatory forbearance to encourage them to take losses sooner and accelerate deleveraging. In this regard, we support methods that worked well in prior periods to allow banks to write off losses, evenly, over the balance of this decade in exchange for requirements that they (i) apply earnings first to plug losses, (ii) end the release of what we regard as insufficient reserves for future losses, and (iii) again suspend dividends. The banking system continues to hold nearly $3 trillion of residential first mortgages and home equity lines that are not, and are not required to be, marked to market – an Achilles heel that remains a systemic risk if housing continues to deteriorate. For that and other reasons, implementing the balance of Dodd-Frank and, in the process, avoiding further erosion of increased capital requirements for SIFI's is something we also regard as important (especially with the phased loss recognition described above).

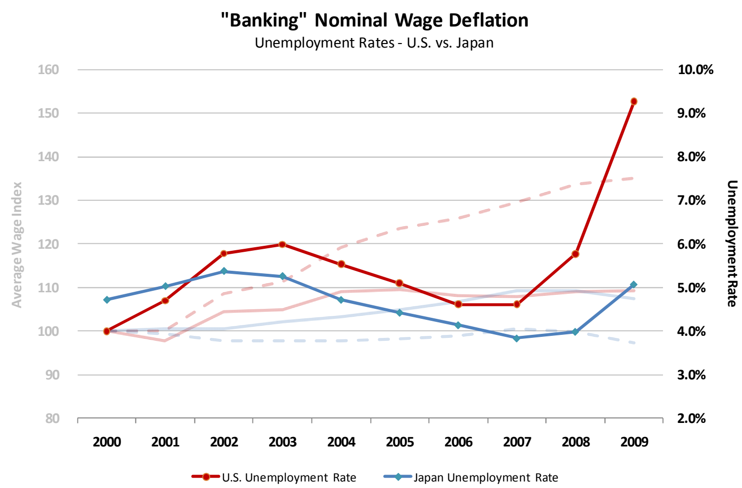
- While fiscal policy initiatives may be decidedly unpopular at the moment, government action should not lag public concern in the event of renewed economic softness. The acolytes of austerity in public spending have their hearts in the right place but are ill timed. Having said that, we think it critical that any fiscal stimulus going forward should be focused, exclusively, on job-producing, physical infrastructure that will pay off in terms of future efficiencies and competitiveness. We would support initiatives executed not through grants or subsidies – which are especially vulnerable to cronyism and poor resource allocation – but rather under the purview of an independent government-owned "infrastructure bank" (once funded, functioning outside the political process), capitalizing projects to be executed under the command of the Army Corps of Engineers, by any measure the world's largest public engineering, design and construction management agency. There are roads, bridges, railways, airports, levees and dams in this country in sore need of repair

[3] We acknowledge that there are many groups with which these proposals will be unpopular, and that implementation would be politically challenging. But rather than continuing to do the wrong thing, it is time to move from the easy to the worthwhile.

and upgrading. If one has been to China recently, upon return to the U.S. the meaning of "developing" is often muddied.

- With regard to monetary policy, we need to rationalize alternatives relative to achievable outcomes. If we are correct, and the fundamental pressure bearing down on wages and prices in the U.S. are disinflationary, then it is more productive to manage the degree of disinflation, rather than to attempt to fight it outright. While policy needs to be cognizant of the risk of a deflationary spiral and cash hoarding, we view that as unlikely under present circumstances. Rather than attempt to manage inflation to a rate of between 1.5% and 2.0% to achieve tolerable price stability while allowing policy makers to subtly reduce real wages, we need to actually encourage a measured reduction in prices of certain essential goods and services – equally as subtly and gradually – in order to permit nominal wages to fall to competitive levels. From the perspectives of both controlled wage reduction and employment, the following graphs offer an interesting comparison.





Source: IMF International Financial Statistics; Bureau of Labor Statistics
(a) U.S. wages based on average hourly compensation for production workers (includes both money earnings and benefits); Japan wages based on average monthly contract cash earnings of regular workers in all industries.

Conclusion

It must be noted that the effect of the foregoing prescriptions would involve dealing with several countervailing forces:

While wages may become more globally competitive, a disinflationary policy will strengthen the dollar. To understand why, consider Japanese deflation's impact on the Yen. A stronger dollar will have a less than desirable impact on the competitiveness of our exports and will make imports cheaper, but our research leads us to believe this factor, if moderated, will be offset by the combination of lower wages and a greater propensity to manufacture for domestic consumption, as well as and costs of dollar denominated inputs (chiefly energy – which is a substantial portion our external imbalance).

While we seek to address fiscal matters through a combination of more effective taxation and spending, we recognize that our suggestions regarding infrastructure investment, to reduce unemployment and increase physical competitiveness, will slow the process of closing the federal budget gap.

Reducing inflation, and expectations of future inflation, by eliminating further monetary stimulus allowing the forces of debt deflation and global competition to have their inevitable impact, will be somewhat muted by re-employment initiatives on the fiscal side.

Finally, allowing natural economics to proceed would enhance the propensity of the household sector to deleverage and save – something the U.S. sorely needs to happen in order to be competitive with countries with much stronger domestic balance sheets. But this will also limit the percentage of GDP coming from consumption, which the U.S. economy has relied on for decades.

Disinflation would, however, shift investment capital allocation from the speculative asset sectors to the productive sectors, as prices fall and production for internal and external demand accelerates. Current account rebalancing, helped further by moderate inflation in the emerging economies, could then proceed.

There is, of course, the pesky matter of settling the $52+ trillion of debt outstanding in the U.S. Conventional wisdom has been that the U.S. doesn't "do pain" very well and our policy makers and business community would surely find a way to reflate the economy in order to effectively devalue the debt (and, in the process, stripping savers of additional wealth and further discouraging saving).

Despite unprecedented fiscal and monetary intervention, we believe that inflation in wages, the necessary ingredient to achieve sustained price growth, is nearly impossible to engineer across the major domestic employment sectors. We can, by feeding liquidity to those interested in speculation, certainly stoke fears of inflation. But those fears, and the impact on the real economy of heightened commodity costs, are – as we are presently observing – not enough to ignite the real thing.

Recent policy has been pushing back against a tsunami of opposing forces. It has prevented developed economies of falling off a cliff, and for workers who are still employed to catch their collective breath. But merely not plunging off that cliff is not the same as finding a bridge across the gorge between current conditions and renewed prosperity. It is time to engage in the harder work required to build that bridge.

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