



# PAISLEY FINANCIAL



## 2011 Macroeconomic Outlook August 2011

“The Strongest Principle of Growth Lies Within Human Choice”



## Paisley Financial

*Rational Investing in an Irrational World*

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## **THE WINDS OF CHANGE**

### **EXECUTIVE SUMMARY**

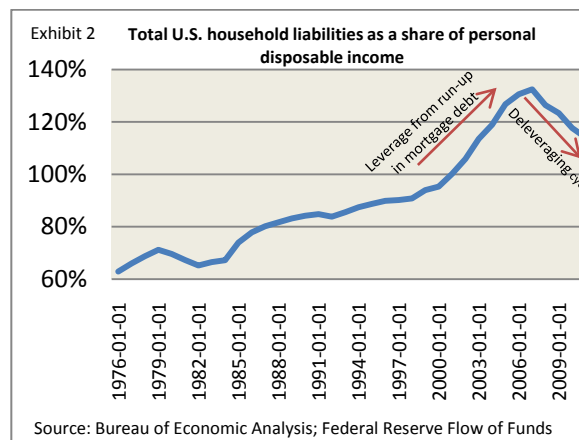
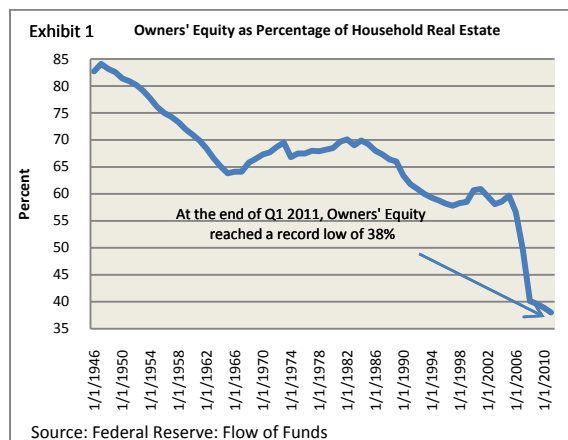
The report relies heavily on the conceptual framework of a U.S economy in a balance sheet recession. Our main thesis rests on the belief that until U.S households repair their balance sheets and generate real income growth, they are in no position to drive a self-sustaining economic recovery. Monetary policy (including quantitative easing (QE)) produces limited results in generating real economic growth--- since the demand for credit and the lack of qualified borrowers remain the issue not the supply of funds. Instead, expansive fiscal policy, through *increased* government budget deficits, exists as the primary lever to raise economic activity, transfer real financial assets to the private sector, and *ease* the pain of the deleveraging cycle.

To provide the foundation for our views on how U.S fiscal and monetary authorities stabilized the U.S economy post the housing crash, set in motion a financial markets recovery starting in March 2009, and now risks sending us into a double-dip recession by pulling the wrong policy lever, we attempt to answer the following questions in the work that follows.

1. What causes a balance sheet recession?
2. Are there lessons to learn from the Japanese experience of the 1990's?
3. What are the cures for this disease?
4. Can fiscal authorities make matters worse?

### **INTRO**

When the U.S housing bubble burst, the effects reached far beyond the decline in home prices and in construction-related employment. The nature of the economic landscape changed. As home values began their descent in 2006 against a backdrop of record mortgage debt, household net worth plunged primarily through a loss of home equity (see exhibit 1). Consumer attitudes shifted from conspicuous consumption to frugality. After several decades of leveraging up the balance sheet and living beyond their means, households started the process of deleveraging characterized by: debt minimization and reduction, increased personal savings, and lower consumption (see exhibit 2). The balance sheet recession commenced and how we look at the economic cycle must change.



*If we could first know where we are,  
And whither we are tending,  
We could better judge what to do  
And how to do it.*

-Abraham Lincoln, 1858

## THE PRECURSOR TO A BALANCE SHEET RECESSION

A debt-financed asset bubble precedes a balance sheet recession. Consequently, we begin by paraphrasing the thoughts of legendary hedge fund manager, Ray Dalio, on the cycle leading up to the collapse. A healthy economic expansion starts with a private sector (corporate or household) agent holding minimal debt. The private sector begins to see income rise at the pace of GDP. At this stage of the economic expansion, the majority of aggregate demand comes from *cash-based income*.

For example, let's assume the private sector spends \$1,000 of cash income (which contributes to the economy); now someone else has \$1,000 of income. As the economy expands, the private sector feels more optimistic and decides to leverage up the balance sheet by going to the bank and borrowing \$100 per year against \$1,000 of income. Now with added funds in hand, the private sector agent decides to spend the full \$1,100, which becomes someone else's income of \$1,100, and contributes an added \$100 of aggregate demand to the economy relative to a scenario with no borrowing at all. The private sector agent earning the \$1,100 income decides to go to the bank and borrow \$150 per year.

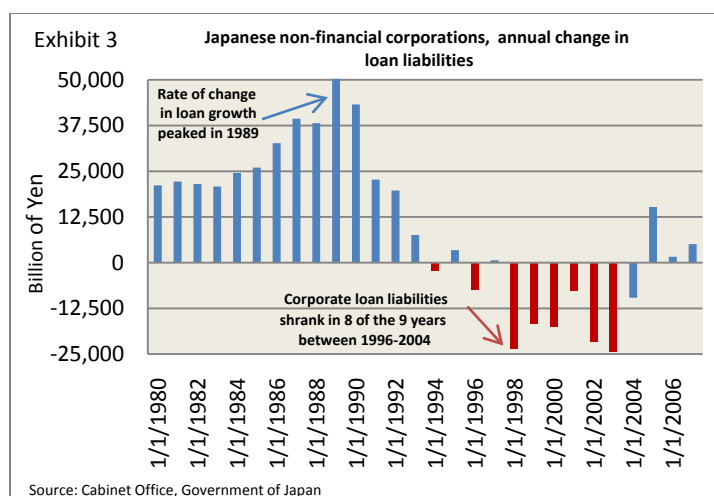
The income and the borrowed funds get spent in full, adds to GDP, and the \$1,250 becomes someone else's income. The private sector agent earning \$1,250 income goes to the bank and borrows \$200 per year. All the funds get spent on goods and services, which add to aggregate demand, and the \$1,450 becomes someone else's income. This becomes a self-reinforcing positive cycle of higher debts and higher income. Unfortunately, debt begins to rise faster than income.

In the later stages of the business cycle, an asset bubble forms. The private sector borrows funds to buy financial assets (eg. houses) in anticipation of higher prices. Essentially, the buying becomes speculative and highly leveraged. The bubble pops when the debt (eg. mortgages) underlying the asset price (eg. houses) rises beyond the ability of private sector income to service the outstanding loan obligation. Asset prices collapse and the liabilities remain. This triggers a balance sheet recession and a long period of deleveraging<sup>1</sup>.

## FEATURES OF A BALANCE SHEET RECESSION

### DEBT MINIMIZATION

Since asset prices decline (eg. house prices) well below the value of corresponding liabilities (eg. mortgages), balance sheets become impaired (eg. negative equity or negative net worth). In order to repair balance sheets, the private sector moves away from profit maximization to debt minimization<sup>2</sup>. The deleveraging cycle ends up reducing funding needs. Unfortunately, with no borrowers, the economy loses aggregate demand equivalent to the sum of un-borrowed savings and debt repayment<sup>3</sup>. Even in a zero interest rate environment, the private sector refrains from taking on added liabilities (see exhibit 3). This outcome renders monetary policy ineffective by creating a liquidity trap.



### DEBT REDUCTION

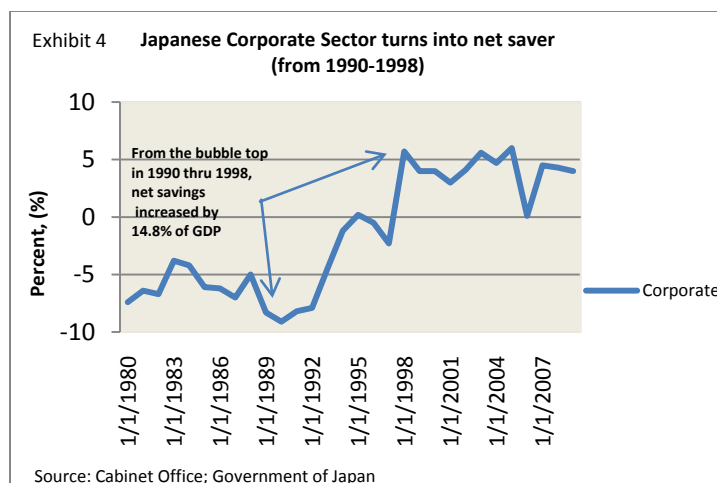
Another way to de-lever resides in debt reduction. In the household sector, the majority of income goes into reducing outstanding liabilities rather than boosting consumption. This translates into a higher personal savings rate. As for the corporate sector, profits and cash balances are used to pay down debt rather than being reinvested back into the business. When the Japanese property and stock bubble burst in

<sup>1</sup> CNBC. (Producer). (2011). *Hedge Fund Titan's Principles* (video file). Available from <http://video.cnbc.com/gallery/?video=3000008442>

<sup>2</sup> Koo, R. (2009). *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*. Singapore: John Wiley & Sons (Asia).

<sup>3</sup> Koo, R. (2010, May). *Lessons from Japan: Fighting a Balance Sheet Recession*. Tokyo, Japan.

1990, corporations turned into net savers by paying down debt and increasing cash balances (see exhibit 4). Bankruptcy and mortgage principle write-downs provide two other options to lower system wide debt.



### ***DEFLATIONARY PRESSURES***

After an asset bubble collapses, private sectors demand contracts. The economy operates below potential GDP. Labor and machinery utilization rates fall from peak levels. Excess labor supply pressures real wages. The output gap naturally exerts downward pressure on inflation. The government becomes the major source of borrowing and spending to offset the lost private sector demand. If fiscal authorities withdraw stimulus before the balance sheet recession ends, the economy risks entering a deflationary environment.

### **LESSONS FROM THE JAPANESE EXPERIENCE**

#### ***QE FAILS TO SPUR BANK LENDING IN A ZERO INTEREST RATE ENVIRONMENT***

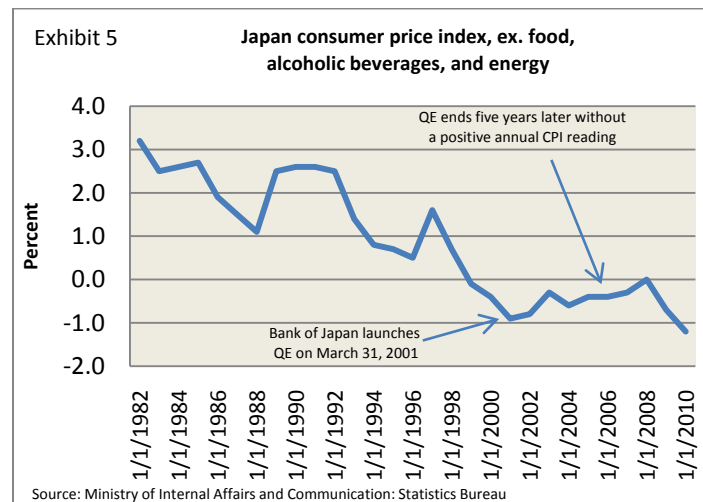
Japan lost a decade of growth after the collapse of its debt-financed bubble economy in 1990. Politicians grew impatient at the economy's lack of progress. The pressure intensified for extreme monetary measures to jumpstart economic growth. Quantitative easing became the tool of choice. Unfortunately, it failed to increase bank lending. Financial institutions did not attempt to rebalance their portfolios by shifting away from excess reserves at the BOJ to loans.<sup>4</sup> As Richard Koo states, "The Bank of Japan (BOJ) argued vigorously that such measures would be *meaningless*, but it was eventually overridden, and in March 2001 then Governor Masaru Hayami made the decision to implement quantitative easing. During the period between March 2001 and March 2006, the Bank of Japan pumped 25 trillion yen of reserves--equivalent of five times banks' required reserves into the system. Yet, the money supply grew only by an amount equal to the increase in government borrowing over private-sector debt repayment

<sup>4</sup> Suda, M. (2003, April 2). Lecture delivered at Nagoya University. Aichi, Japan.

during this period”. He goes on to explain why QE fails to work in a zero interest rate environment, “The central bank’s implementation of quantitative easing at a time of zero interest rates was similar to a shopkeeper who, unable to sell more than 100 apples a day at 100 Yen each, tries stocking his shelves with 1,000 apples, and when that has no effect, adds another 1,000. As long as the price remains the same, there is no reason consumer behavior should change--sales will remain stuck about 100 even if the shopkeeper puts 3,000 apples on the display”.<sup>5</sup>

### ***QE FAILS TO ALTER LONG-TERM INFLATION EXPECTATIONS***

Japanese policymakers confronted another roadblock to economic recovery. Besides the lack of private sector borrowing emanating from the balance sheet recession, low inflation rates risked discouraging consumption and investment spending. After the bubble burst in 1990, Japanese CPI rates declined from an annual peak of 2.6% to a negative reading as early as 1999 (see exhibit 5). As a result, Japan tried to eradicate deflationary pressures. Over the program’s five-year period, the BOJ increased the reserve target nine times and (similar to the U.S Fed in 2009) increased its purchases of longer-dated Japanese government securities. Furthermore, the central bank promised to maintain the policy until core CPI reach zero or increased on a y-o-y basis for several months, which equated to setting an inflation target.<sup>6</sup> While inflation turned positive in the first quarter 2006, it did so by a paltry 0.2%. The QE policy ended and Japan fell back into deflation by year’s end, with an annual 2006 CPI reading of -0.4%. In fact, up to the year 2010, the highest Japanese annual CPI reading came in at 0% in 2008 during the peak of the commodity boom.

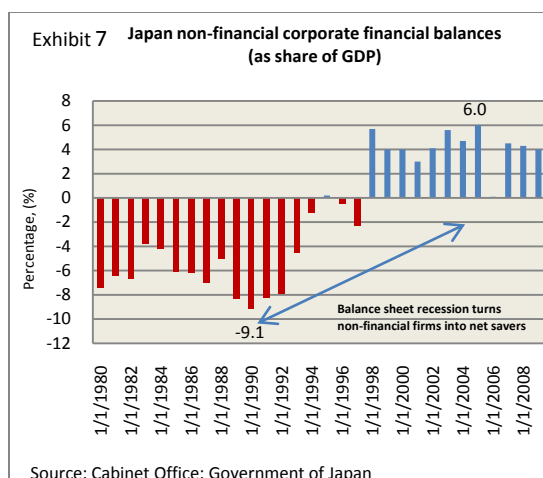
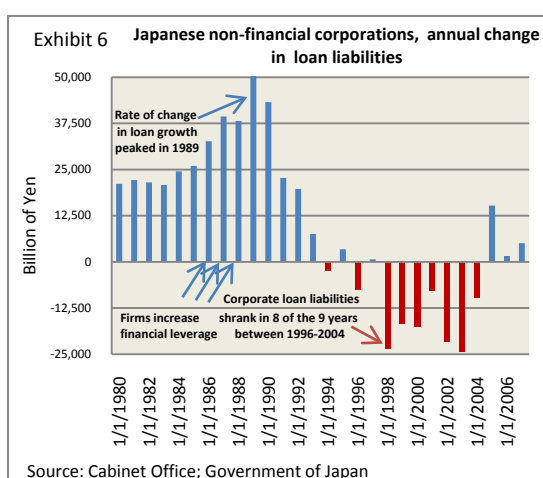


<sup>5</sup> Koo, R. The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession. Pp. 73-74.

<sup>6</sup> Humpage, O., & Shenk, M. (2008). “Japan’s Quantitative Easing Policy”. Retrieved from <http://www.clevelandfed.org/research/trends/2008/1208/01intmar.cfm>

## **GOVERNMENT SPENDING PROVIDES A KEY SOURCE OF DEMAND IN A BALANCE SHEET RECESSION**

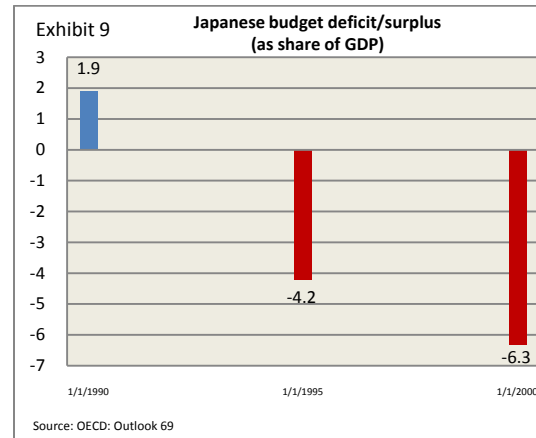
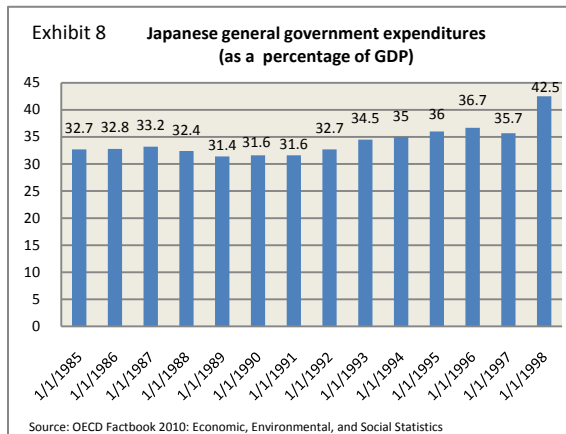
Being a massive net borrower from 1984 to 1989, the Japanese corporate sector increased their financial leverage going into 1990. And according to the San Francisco FED, “after Japan’s bubble burst, private nonfinancial firms undertook a painful deleveraging, reducing their debt-to GDP ratio from 125% in 1991 to 95% in 2001”.<sup>7</sup> From 1991 to 1995, the rate of growth in loan liabilities fell precipitously, and from 1996 to 2004, net loan liabilities shrank in all but one year (see exhibit 6). As firms reduced their spending on investment and became net savers, the economy lost a source of demand—estimated at -15.1% of GDP from the peak in 1990 to 2005 (see exhibit 7).



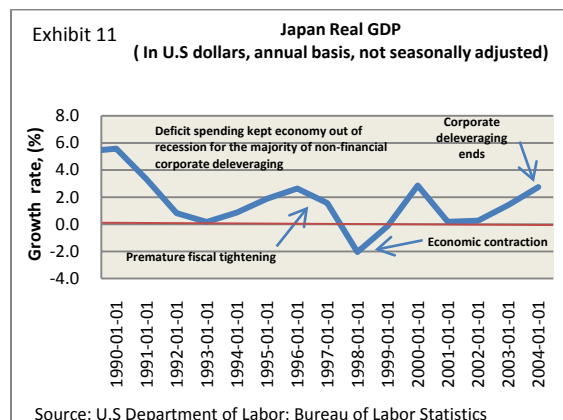
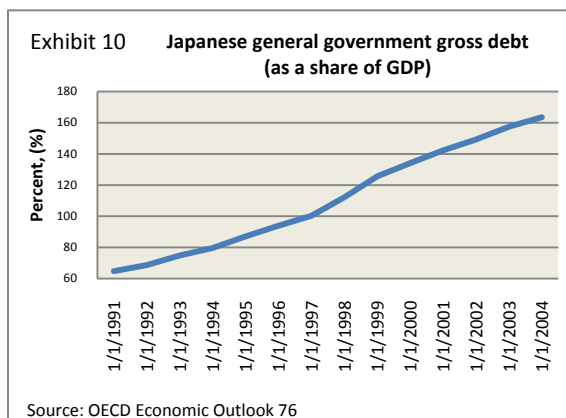
The government decided to pursue an expansive fiscal policy to alleviate the economic pain from private sector deleveraging. During the 1990’s, Japan adopted seven different stimulus packages designed to increase aggregate demand and enhance economic growth. Government spending on infrastructure, such as on roads, bridges, and airports, increased substantially<sup>8</sup>. To give an idea of the fiscal largesse, general government expenditures rose from more than 31.6% of GDP in 1990 to 42.5% of GDP in 1998 (see exhibit 8). In eight short years, Japanese government spending rose by 10.9% of GDP. As borrowing increased to finance fiscal expenditures, the budget went from a surplus of 1.9% in 1990 to a deficit of 6.3% in 2000 (see exhibit 9).

<sup>7</sup> Glick, R., & Lansing, K. (2009). U.S Household Deleveraging and Future Consumption Growth. Retrieved from <http://www.frbsf.org/publications/economics/letter/2009/el2009-16.html>

<sup>8</sup> South-Western Cengage Learning (2009). Special Topic 7: Lessons from the Japanese experience. Retrieved from <http://www.cengasites.com/academic/assets/sites/Gwartyney/ch7.pdf>.



Persistently higher deficits add to national debt levels. Japan’s long-term debt outstanding as a percentage of GDP soared from 64.8% in 1991 to 163.5% in 2004 (see exhibit 10). But remember after the bubble burst, the corporate sector undertook a massive deleveraging and the economy lost a big demand source. The private sector experienced a negative wealth effect from falling land and stock prices. Since 1990, cumulative capital losses on stock and land totalled \$15 trillion, or 3 years worth of Japanese GDP.<sup>9</sup> The banking system, saddled with non-performing loans, turned cautious about extending new credit. Monetary policy produced nothing more than a liquidity trap—the equivalent to pushing on a string. To avoid a severe recession and a vicious deflationary cycle, the government was left with no choice but to borrow and spend the savings of the private sector. Deficit spending kept real GDP out of negative territory for all but one year, which was an amazing achievement (see exhibit 11). Without massive fiscal stimulus, Japan’s GDP could have fallen to between one-third to one-half its peak.<sup>10</sup>



<sup>9</sup> Koo, R. Lessons from Japan: Fighting a balance sheet recession.

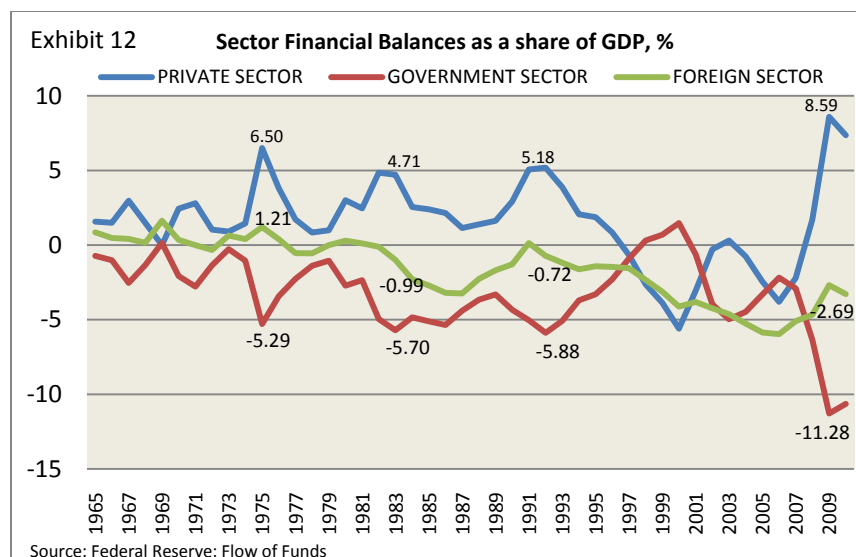
<sup>10</sup> Koo, R. The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession. p25.

### GOVERNMENT DEFICITS HELP IN A BALANCE SHEET RECESSION

To understand why government deficits help in a balance sheet recession, let's briefly discuss the sector financial balances (SFB) model. The model displays the financial flows between the various sectors of the economy, including the government (federal, state, and local), private sector (households and corporations), and foreign sector (exports and imports). The original SFB model was based on a closed economy. Thanks to Stephanie Kelton, we present an open-economy accounting identity incorporating international flows (see below)<sup>11</sup>.

The *domestic private balance* equals the net savings of households and corporations. It is the addition or subtraction to net financial wealth for the private sector in a given time period. If the private sector engages in net borrowing, then its balance will be negative. Conversely, private sector net savings creates a positive (surplus) balance<sup>12</sup>. The *current account balance* is the difference between a country's total exports of goods, services, and transfers relative to its total imports of them. When a country exports more than it imports, then its current account balance will be positive. Also, a positive balance means the private sector accumulates net financial claims on foreigners. With a negative current account balance, the country imports more than it exports and foreigners accumulate claims on the private sector.

The *Government account balance* equals the difference between total expenditures (spending) and revenue (taxes). When spending exceeds tax collections, deficits will increase and the opposite holds true if taxes exceed total spending. As a result, *for the private sector to save, the government deficit must be larger than the current account deficit*. If the Government sector reduces the deficit or runs a surplus, the private sector experiences lower net savings. The chart shows the U.S. sector financial balances as a share of GDP from 1965 to 2010 (see exhibit 12).



<sup>11</sup> Kelton, S. (2011). What happens when the Government tightens its belt? (Part 2). Retrieved from <http://neweconomicperspectives.blogspot.com/2011/06/what-happens-when-government-tightens.html>

<sup>12</sup> Fulwiller, S. (2009). The Sector Financial Balances Model of Aggregate Demand—Revised. Retrieved from [http://neweconomicperspectives.blogspot.com/2009/07/sector-financial-balances-model-of\\_26.html](http://neweconomicperspectives.blogspot.com/2009/07/sector-financial-balances-model-of_26.html)

Private sector balances display a high inverse correlation to government sector balances. In the data points chosen, all government deficits resulted in private sector surpluses. Let's plug the numbers into the equation below.

$$\text{Domestic Private Surplus} = \text{Government Deficit} + \text{Current Account Balance}$$

1975--	6.50%	=	5.29%	+	1.21%
*1983--	4.71%	=	5.71%	+	(-0.99%)
*1992--	5.18%	=	5.88%	+	(-0.72%)
2009--	8.59%	=	11.28%	+	(2.69%)

\*Rounding error

The numbers add up! The key takeaway: *Fiscal policy remains the only real tool available to cure a balance sheet recession.* Government deficits larger than current account deficits transfer financial savings to the private sector. Given the private sector shifts from a net borrowing to a net saving position (i.e. pay down debt, retain income, lower consumption) in a balance sheet recession, increasing government deficits ease the pain from the deleveraging process.

Other balance sheet recession cures include income growth and time. The faster real private (household or corporate) income growth rises, the sooner leverage ratios return to healthy levels. Obviously, higher levels of private sector financial leverage take longer to unwind than lower levels. Japan took 15 years to overcome its balance sheet recession.<sup>13</sup> There is no short-term fix.

### CAN FISCAL AUTHORITIES MAKE MATTERS WORSE?

Fiscal policy remains the only real tool available to help a country through a balance sheet recession. With households or firms having no choice but to repair their balance sheets, the only way to prevent a recession and a money supply contraction centers on the government expanding budget deficits and borrowing & spending the savings of the private sector. So why would policymakers want to unwind fiscal stimulus or impose austerity during a balance sheet recession?

First, they believe austerity improves private sector confidence, where households boost spending and businesses boost investment. Second, they worry bond vigilantes may impose higher sovereign bond yields as a punishment for no austerity measures. Third, a large percentage of citizens dislike big government. So when an economy starts to recover, it provides an ideal cover to get rid of excess government spending. We disagree on all counts. Policymakers assume households and firms will re-lever an already damaged balance sheet. However, in balance sheet recessions, the private sector stays in deleveraging mode until balance sheets get healthy. This means less household spending and less

<sup>13</sup> Koo, R (2010). U.S Economy in Balance Sheet Recession: What the U.S can learn from Japan's experience in 1990-2005. P.8. Retrieved from [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/richardc.koo.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/richardc.koo.pdf)

corporate investment. As for fears of a hostile bond market, if the sovereign government issues debt in its own currency, austerity might actually drive yields sharply lower on fears of a deep economic contraction. Finally, imposing austerity before the private sector repairs its balance sheet increases the odds of a major slowdown. A cutback in government spending makes more sense when the private sector stands ready to carry the economic torch. As Richard Koo states, for deficit reduction to succeed, “policymakers must make certain that funds left un-borrowed by the government will be borrowed and spent by the private sector. Otherwise, they risk triggering the kind of economic collapse seen in the U.S in 1937 and in Japan in 1997”.<sup>14</sup>

Japan provides a clear example of what happens to an economy when fiscal tightening occurs before private sector deleveraging ends. After a real GDP growth rate of 1.9% in 1995 and 2.6% in 1996, the government expected the economic recovery to be self-sustaining and turned its attention to belt-tightening. So in 1997, Japan decided to pursue fiscal consolidation. By increasing the consumption tax rate from 3% to 5%, increasing taxpayers’ share of social security costs, ending a special income tax, and shelving a supplementary budget, Prime Minister Hashimoto intended to reduce the fiscal deficit by 15 trillion yen (stood at 22 trillion yen).<sup>15</sup> The consumption tax alone would cost the household sector upwards of 5 trillion yen. The measures undercut the fragile Japanese recovery. The economy ended up shrinking for five consecutive quarters, with FY98 real GDP contracting 2% (refer to exhibit 11). National revenue from income and corporate taxes dropped to 47 trillion yen in FY99 from 52 trillion Yen in FY96.<sup>16</sup> Instead of deficit reduction, the FY99 deficit increased to 38 trillion Yen from the original starting point of 22 trillion Yen. A couple years later, Prime Minister Junichiro Koizumi capped new government bond issuance and it led to another economic slowdown in 2001-2002. These examples illustrate the risks to fiscal consolidation-- amid a balance sheet recession--slower economic growth, lower tax receipts, and higher budget deficits.

### **IS THE U.S FOLLOWING IN THE FOOTSTEPS OF JAPAN?**

Japanese corporations borrowed heavily to purchase real estate at the height of the real estate bubble. When commercial property values collapsed from their peak, most firms found themselves “upside down” on the loans. This left a huge gap on their balance sheet, which required years of deleveraging. How about the United States?

When the dot-com bubble burst in 2000, the Federal Reserve responded with a series of aggressive rates cuts, taking the federal funds rate down from 6.5% to 1% by 2003<sup>17</sup>. The 30-year conventional mortgage rate fell more than 300 basis points (see exhibit 13). With lax lending standards, the rise of securitization, and the aforementioned lower mortgage rates, the stage was set for a debt-financed asset bubble.

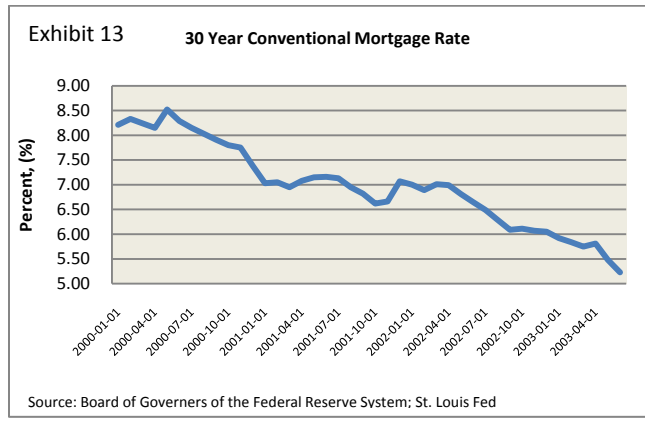
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<sup>14</sup> Koo, Richard. The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession. p.6.

<sup>15</sup> Koo, R. pp. 52-53.

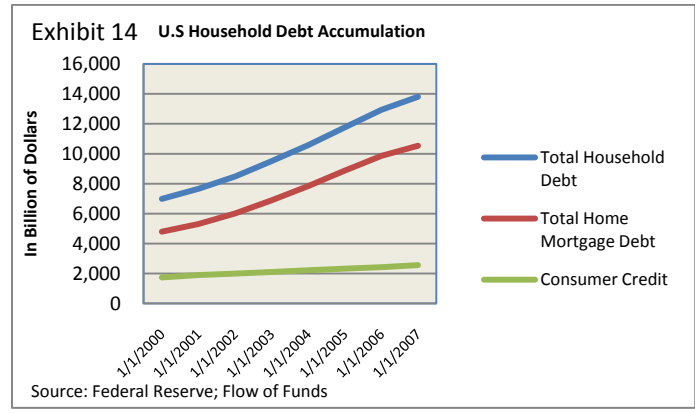
<sup>16</sup> Japan Press Weekly. Consumption Tax Rate at 10%! Retrieved from <http://www.japan-press.co.jp/modules/news/indeg.php?id=61>

<sup>17</sup> Federal Reserve Bank of New York. Historical Changes of the Target Federal Funds and Discount Rates. Retrieved from <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>



With many households believing real estate to be the safer investment than stocks, money flowed out of equities and into the property market. As home prices started to rise at a double-digit annual pace, homeownership became widely viewed as a one-way ticket to riches. Do you blame them? According to the S&P/ Case-Shiller Index, between the first quarter of 2000 and the second quarter of 2006 (the peak), nationwide home prices rose an astonishing 89.93%<sup>18</sup>.

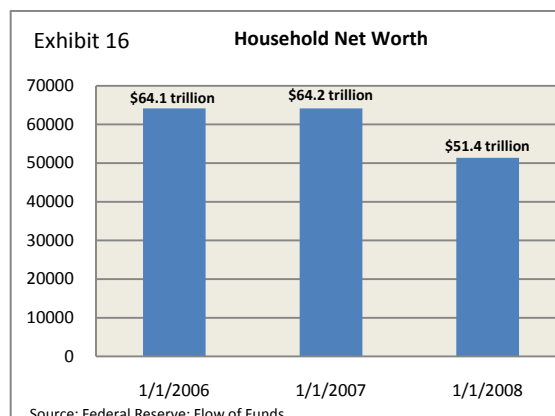
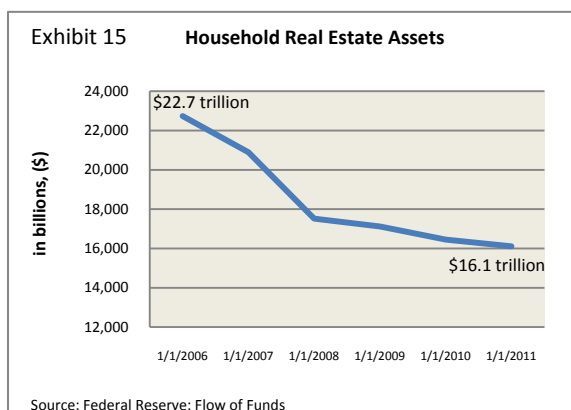
Unfortunately, U.S households borrowed heavily to purchase homes during the run-up in prices. From the years 2000 to 2007, total home mortgage debt increased approximately 120% to \$10.54 trillion. During the same period, total consumer credit increased approximately 47% to \$2.56 trillion. In sum, total household debt increased approximately 98% to \$13.81 trillion (see exhibit 14). When the property bubble burst, many U.S homeowners were turned “upside down” on their loans. This left a gap in their balance sheet and years of painful deleveraging ahead.



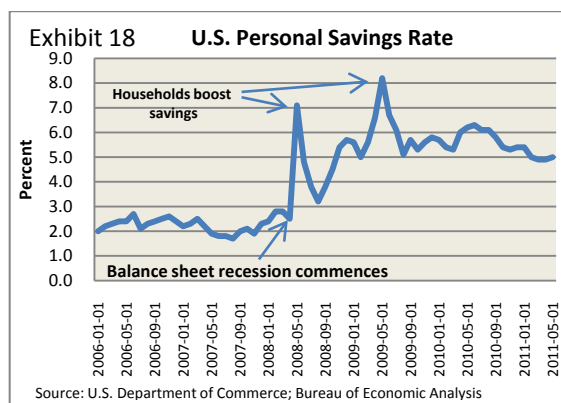
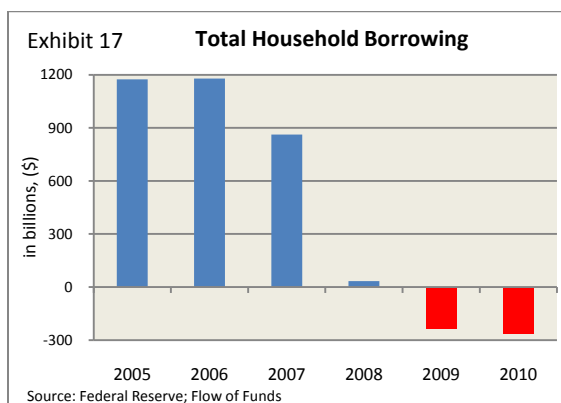
<sup>18</sup> Standard & Poor’s. S&P/Case-Shiller Home Price Indices. Data retrieved from [http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff-p-us---](http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff-p-us-)

### U.S. HOUSEHOLDS START THE DELEVERAGING PROCESS

From its high of \$22.7 trillion, the total value of household real estate assets plunged \$5.2 trillion by year-end 2008 (see exhibit 15). Household net worth fell an astonishing \$12.7 trillion between 2006 and year-end 2008 (see exhibit 16). Household mortgage liabilities had fallen a miniscule \$44.5 billion from the peak in 2007. Going into 2009, U.S. households carried too much debt relative to the size of their assets. They began to pull back in typical, balance sheet recession style.



Just like in Japan, debt minimization took hold in the United States. Households went from being major net borrowers during the height of the bubble to net savers in 2009 and 2010 (see exhibit 17). Between 2006 and 2010, the economy lost approximately \$1.4 trillion in private sector demand from lower household funding needs. Consumers started to reduce consumption and pay down debt. In 2009 alone, households paid down \$268.8 billion of total household debt, amounting to \$153.6 billion of mortgage debt and \$115.2 billion of consumer credit debt. In addition, they started setting more money aside for a rainy day. Between May of 2008 and May of 2009, the personal saving rate increased from 2.5% to 8.2% (see exhibit 18).



## THE RESPONSE FROM U.S POLICYMAKERS

### TAILWIND # 1: EXPANSIVE FISCAL POLICY

The U.S. government decided to pursue an expansive fiscal policy to alleviate the economic pain from household sector deleveraging. During the economic and financial crisis, the U.S implemented two major stimulus packages (costing nearly \$1.65 trillion over ten years) designed to increase aggregate demand, boost economic growth, and promote employment growth. First, on February 17, 2009, President Barack Obama signed into law the \$787 billion American Recovery and Reinvestment Act of 2009 (ARRA), which contained a broad mixture of increased spending and tax cuts (see Table 1). Government spending on health care, education, and infrastructure increased substantially under this bill-- by more than \$324 billion.<sup>19</sup> The other major provision included \$116 billion for the “Making Work Pay Tax Credit”, which provided a refundable tax credit of up to \$400 for working individuals and up to \$800 for married couples filing joint returns.<sup>20</sup> Also, Congress temporarily extended five stimulus provisions from the ARRA at a cost of \$61 billion.<sup>21</sup>

Purchases of Goods and Services by Federal Government	\$88 billion
Transfers to State and Local Governments for Infrastructure	\$44 billion
Transfers to State and Local Government for Education and for State Fiscal Relief Fund	\$215 billion
Transfers to Persons (such as unemployment compensation; health insurance assistance)	\$100 billion
One-Time Payments to Retirees	\$18 billion
Two-Year Tax Cuts for Lower- and Middle-Income People	\$168 billion
One-Year Tax Cuts for Higher-Income People	\$70 billion
Extension of First-Time Homebuyer Credit	\$7 billion
Tax Provisions for Businesses	\$21 billion
Total	<u>\$732 billion</u>

*Source: Congressional Budget Office.*

\*The costs fail to add up to the total budgetary cost of \$787 billion for two reasons. First, the CBO states, “that several provisions are excluded because CBO’s analysis of them cannot easily be summarized by a single multiplier”.

Second, the CBO states, “the costs presented here are translations of budgetary costs to categories of the national income and product account”.

Second, more than 18 months later on December 17, 2010, President Barack Obama signed into law The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (see Table 2). The bill’s largest provisions included extending the Bush-era tax rates on income and capital gains &

<sup>19</sup> Committee for a Responsible Federal Budget. (2009). Analysis of the American Recovery and Reinvestment Act. Retrieved from [http://crfb.org/sites/default/files/imported/documents\\_1/StimulusAnalysis.pdf](http://crfb.org/sites/default/files/imported/documents_1/StimulusAnalysis.pdf)

<sup>20</sup> Internal Revenue Service. (2011). The Making Work Pay Tax Credit. Retrieved from <http://www.irs.gov/newsroom/article/0,,id=204447,00.html>

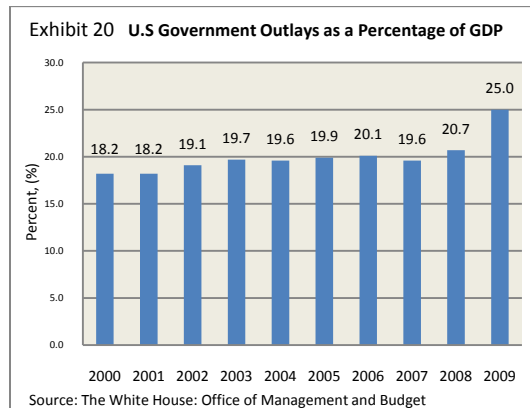
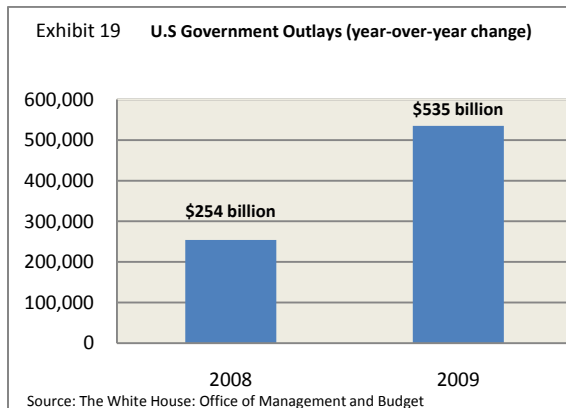
<sup>21</sup> Committee for a Responsible Federal Budget. (2010). Happy Birthday ARRA: The American Recovery and Reinvestment Act One Year Later. Retrieved from [http://crfb.org/sites/default/files/ARRA\\_One\\_Year\\_Later.pdf](http://crfb.org/sites/default/files/ARRA_One_Year_Later.pdf)

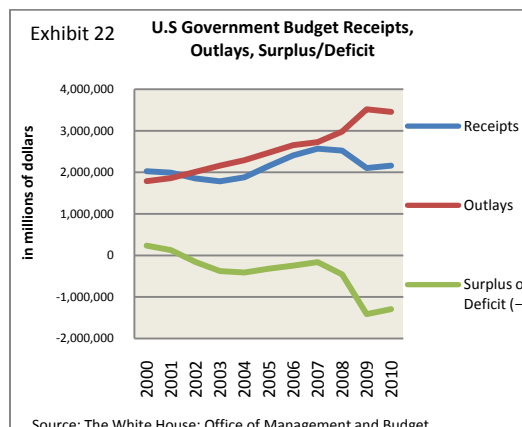
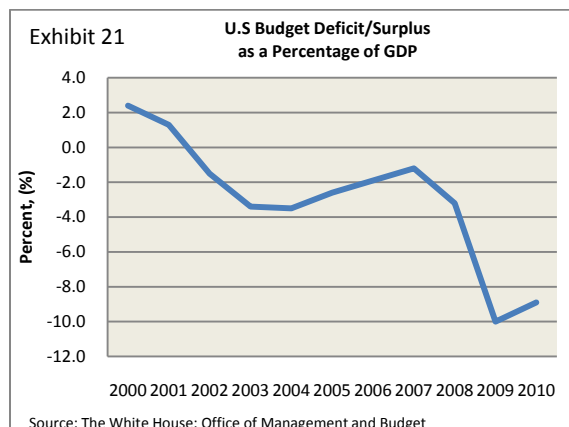
dividends until the end of 2012 (\$408 billion), providing an AMT patch in 2010 and 2011(\$137 billion), and enacting a payroll tax holiday for one year, 2011 (\$112 billion).

Temporary Extension of Tax Relief	\$408 billion
Temporary AMT Relief	\$137 billion
Temporary Estate and Gift Relief	\$68 billion
Temporary Extension of Investment Incentives	\$22 billion
Temporary Extension of Unemployment Insurance	\$56 billion
Temporary Payroll Tax Holiday	\$112 billion
Temporary Extension of Certain Expiring Provisions	\$55 billion
<b>Total</b>	<b>\$858 billion</b>

*Source: Congressional Budget Office and the staff of the Joint Committee on Taxation*

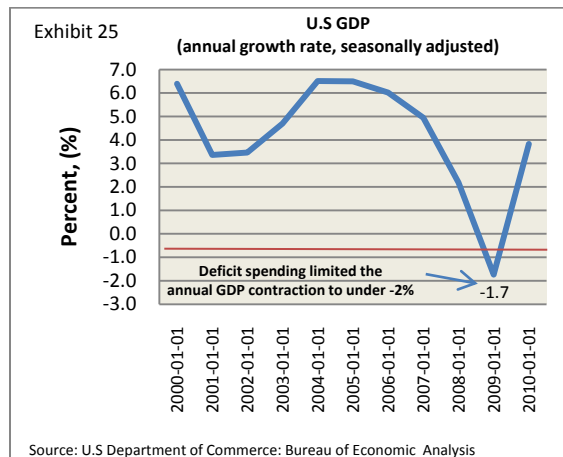
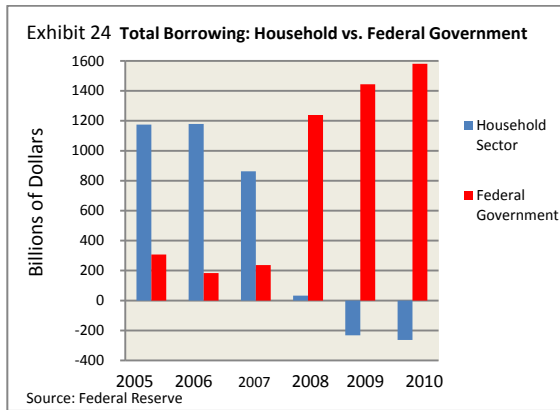
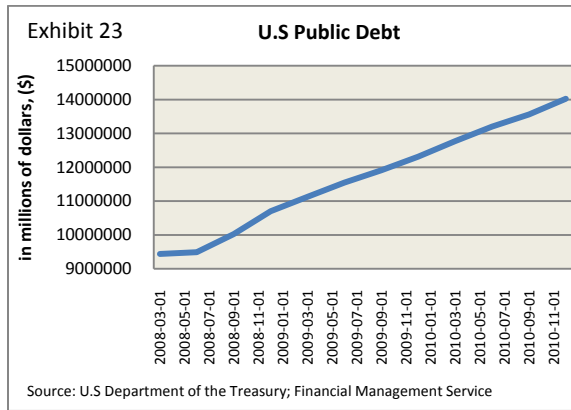
As a result of these stimulus measures, U.S government outlays (spending) increased by more than \$535 billion in 2009 (see exhibit 19). The size of government grew relative to the economy. By fiscal year-end 2009, government spending represented one quarter of GDP (see exhibit 20). As borrowing increased to finance fiscal outlays, the budget position deteriorated from a deficit of 1.2% in 2007 to a massive deficit of 10% by 2009 (see exhibit 21). With outlays far outstripping receipts, the 2009 budget deficit totaled approximately \$1.4 trillion, up almost \$1 trillion compared to the same period a year ago (see exhibit 22).





Persistently higher deficits add to national debt levels. The U.S public debt soared from \$9.4 trillion in 2008 to \$14.0 trillion in 2010, which equates to a 48% gain in a little over three years (see exhibit 23). But similar to Japan, when the bubble burst, there was a serious period of deleveraging. From the peak in 2006 to 2010, the economy lost approximately \$1.4 trillion in private sector demand due to the decline in household borrowing. Households experienced a negative wealth effect from lower home and stock prices. Monetary policy produced limited results for the real economy. To avoid a severe recession and a vicious deflationary cycle, the government was left with no choice but to borrow and spend the savings of the household sector. As Richard Koo states, “when someone saves money or pays down debt in a national economy, GDP will shrink unless someone else steps in to borrow and spend those saved or repaid funds. Unborrowed funds remain trapped, constituting a leakage from the income stream and a deflationary gap in the economy. If left unchecked, this gap will throw the economy into a deflationary spiral as the economy loses demand equivalent to the saved but unborrowed funds each year.”<sup>22</sup> Fortunately, U.S government borrowing increased by \$1.4 trillion, providing an offset to household deleveraging during the same period. (see exhibit 24). The expansion of U.S fiscal deficits limited the annual 2009 U.S GDP contraction to -1.7% (see chart 25). Without massive government spending, the U.S economy could have fallen much farther from the peak. Going into March 2009, the stock market had priced in a worst-case scenario. When expansive fiscal stimulus took a near-term depression off the table, U.S financial markets found a tailwind behind which to recover.

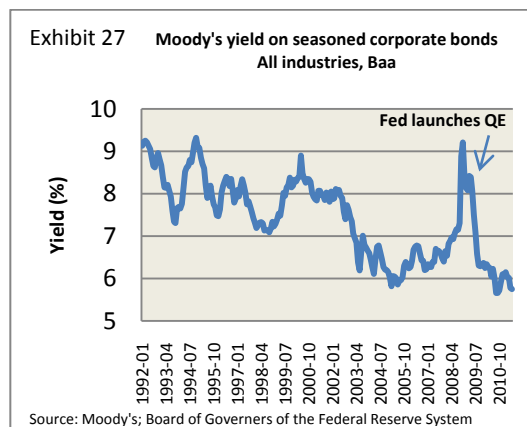
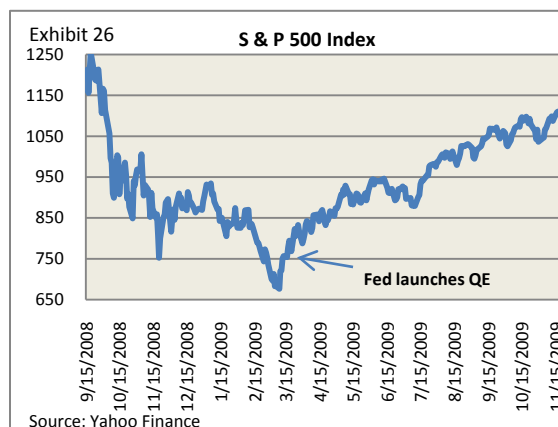
<sup>22</sup> Koo, R. U.S. Economy in Balance Sheet Recession: What the U.S. can learn from Japan’s experience in 1990-2005. p.3.



## TAILWIND #2: MONETARY EASING

By early 2009, the Federal Reserve (FED) had lowered the federal funds rate all the way down to zero. Yet, the economy remained fragile and financial markets illiquid. Ben Bernanke turned to his policy toolbox and found an unconventional measure. On March 18, 2009, the FED formally launched a \$1 trillion-plus QE program consisting of the purchase of an additional \$750 billion of agency mortgage-backed securities, \$100 billion of agency debt, and up to \$300 billion of longer-term Treasury Securities.<sup>23</sup> The financial market reaction was nothing short of extraordinary. The S&P index rallied from near-record low levels, and corporate funding costs declined substantially (see exhibit 26 & exhibit 27).

<sup>23</sup> Board of Governors of the Federal Reserve System. (2009). Retrieved from <http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm>.



Quantitative easing helped trigger a market rally based on several investor-held beliefs. First, QE would help restore market liquidity and alleviate distressed securities pricing created by previously, illiquid markets. Second, QE equals FED money printing. As a result, investors purchased stocks and commodities as a hedge against future inflation. Third, QE spurs real economic growth, money supply growth, bank lending, and job creation. Essentially, investors bet QE would create the conditions necessary for a self-sustaining economic recovery.

We concur on the first point and disagree on the last two. The markets rallied on the liquidity provided by the Federal Reserve. However, QE only worked effectively to stoke financial asset values because it was implemented during a time of market illiquidity. We base our argument on the results from the BOJ's venture into targeted asset purchases and a larger –than–necessary balance sheet to maintain the zero interest rate policy. For example, Kazuo Ueda states that “credit easing seems to be effective only when there is a large market which experiences a major disruption, say, a significant decline in market liquidity”. Others draw a similar conclusion. Curdia and Woodford findings indicate that by introducing financial disruptions, the composition of the central bank balance sheet matters.<sup>24</sup> Consequently, the central bank's decision to target asset purchases and hold more non-traditional assets on its balance sheet works to ease credit conditions if the asset in question is disrupted by a sharp decline in liquidity.

Conversely, QE-driven asset purchases lose effectiveness during normalized financial conditions. Curdia and Woodford point out that “when there are no frictions in the financial system, or more precisely, when assets are valued only for their pecuniary returns and when all investors can purchase arbitrary quantities of the same asset at the same price, neither the size nor the composition of the central bank balance sheet matters”.<sup>25</sup>

Does QE equal money printing? Well, many investors purchased financial assets across the board on the notion of Fed money printing. If the majority of investors perceive QE to be money printing, which we believe occurred, perception becomes near-term reality. Financial assets had a strong bid under them.

<sup>24</sup> Ueda, Kazuo. (2010). The Bank of Japan's Experience with Non-Traditional Monetary Policy. p.4. Retrieved from <http://www.bos.frb.org/RevisitingMP/papers/Ueda.pdf>

<sup>25</sup> Ueda, K. P.4.

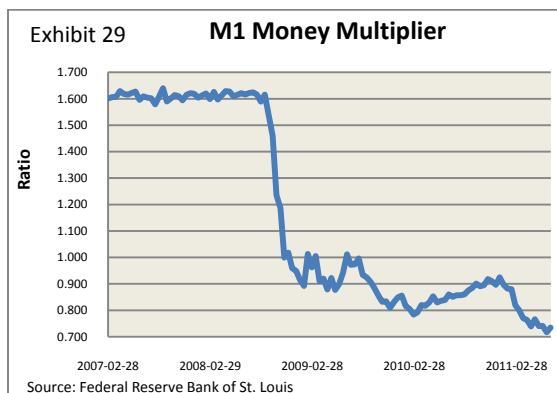
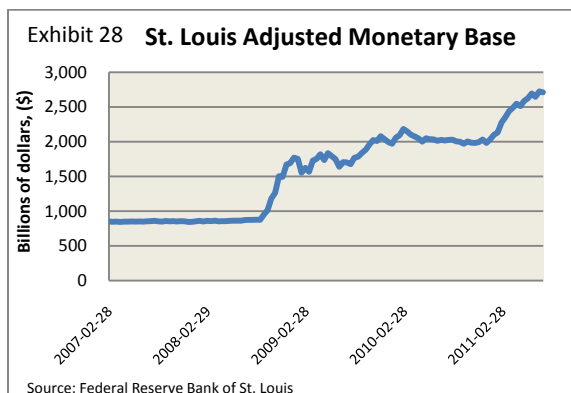
However, a couple problems arise from this situation. First, if QE results in asset prices rising higher than fundamentally justified by the underlying cash flow, then a valuation bubble risks destabilizing an already-fragile financial system. Second, the FED chairman himself says QE is not money printing. Courtesy of a C-Span video, Ben Bernanke states, “What the purchases do is if you think of the Fed’s balance sheet, when we buy securities, on the asset side of the balance sheet, we get the Treasury securities, or in the previous episode, mortgage-backed securities. On the liability side of the balance sheet, to balance that, we create reserves in the banking system. Now, what these reserves are is essentially deposits that commercial banks hold with the Fed, so sometimes you hear the Fed is printing money, that’s not really happening, the amount of cash in circulation is not changing. What’s happening is that banks are holding more and more reserves with the Fed”.<sup>26</sup> In other words, the Fed conducts an asset swap with the private sector—exchanging non-interest bearing assets (deposits or reserves) for interest-bearing assets (treasuries or mortgage-related securities). As a result, if market perception toward QE changes to reflect the true non-inflationary nature of the program, share prices could trade back down to their underlying fundamental value.

What did an extraordinary U.S. monetary response do for the money supply, bank lending, and the labor market? Ironically, while QE acted as a tailwind for a financial markets’ recovery, the policy produced limited results for the real economy. First, in an effort to stabilize short-term funding markets, the Fed supplied a large quantity of reserves into the banking system. The monetary base (includes currency in circulation and bank reserves held at the FED) more than tripled from \$850 billion in 2007 to the current level of \$2.7 trillion (see exhibit 28). Almost immediately, many observers expected a soaring money supply and massive inflation. The fears never came to pass. Due to the plunging money multiplier ratio, the growth in money supply lagged behind the growth in the monetary base. Let’s take a look at the numbers.

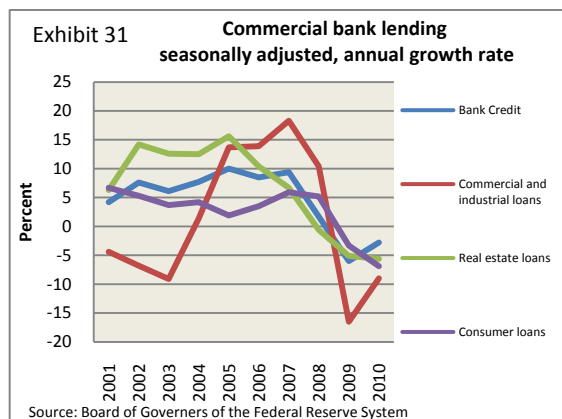
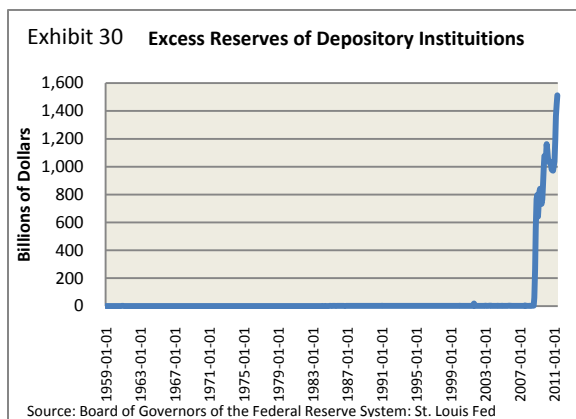
The money multiplier ratio, which measures the increase in money supply per dollar increase in the monetary base, fell more than 50% from its 2007 level. In fact, the current M1 money multiplier ratio has never been this low (see exhibit 29). For the bi-weekly period ending July 13, 2011, a \$1 increase in the monetary base (reserves) resulted in only a \$0.73 increase in the money supply. Until households begin relevering balance sheets, we see limited inflation risk from banks holding excess reserves.

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<sup>26</sup> C-Span (Producer). (2010). *Jacksonville University Finance Discussion* (video file). Retrieved from <http://pragcap.com/ben-bernanke-explains-fed-qe>



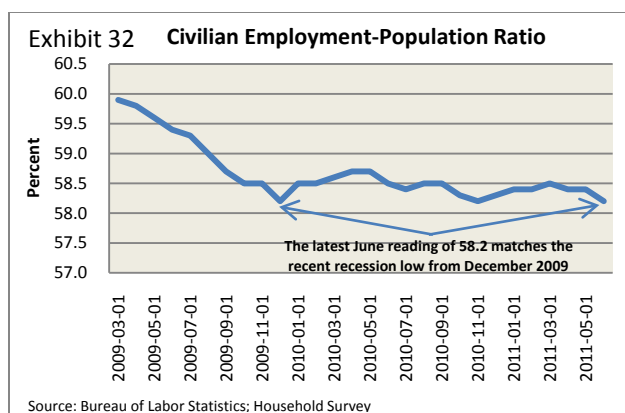
Second, many investors assume an increase in reserves automatically translates into higher loan growth. But the facts say otherwise in a balance sheet recession. Despite the Fed’s effort in supplying a massive amount of reserves balances into the banking system, bank lending contracted. When households choose to deleverage, they take on less debt. Credit demand plunges. On the supply side, commercial banks find fewer *private*, creditworthy customers. Hence, banks sit on excess reserves and monetary policy amounts to nothing more than a modern-day liquidity trap (see exhibit 30). Since the beginning of QE, commercial bank lending remains under pressure. In 2009, bank credit and consumer loans declined 6.0% and 3.3%, respectively. And last year, bank credit and consumer loans declined 2.8% and 6.9%, respectively (see exhibit 31).



Even a staff working paper published on the Fed site posed the question of whether or not an increase in reserve balances leads to an increase in money and lending. The authors state, “ The results in this paper suggest that the quantity of reserve balances itself is not likely to trigger a rapid increase in lending. To be sure, the low level of interest rate could stimulate demand for loans and lead to increased lending, but the

narrow, textbook money multiplier does not appear to be a useful means of assessing the implications of monetary policy for future money growth or bank lending”.<sup>27</sup>

Third, quantitative easing failed to improve the employment picture. The civilian employment-population ratio measures the ratio of employed civilians to the total population. Since the start of QE, there has been no visible improvement in the overall labor market. In fact, the latest June reading of 58.2 matches the recent recession low from December 2009 (see exhibit 32). With QE unable to significantly increase the money supply, bank lending, or jobs, we argue monetary policy contributed very little to the real economy. What it did produce ended up hurting households. As irrational fear over QE’s inflationary impact gripped financial markets, investors bid up commodity prices and lowered consumer discretionary spending in the process.



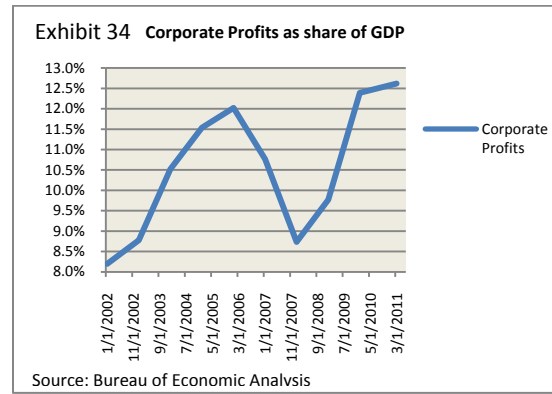
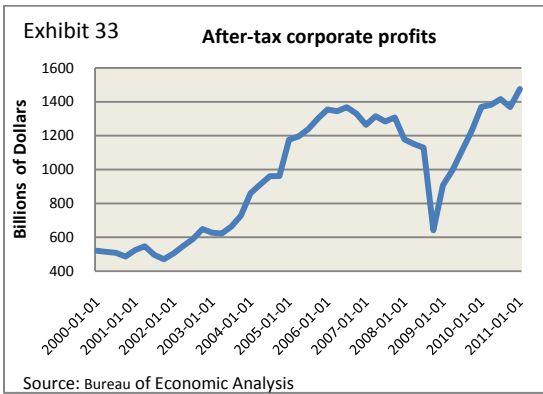
### TAILWIND #3: HIGHER CORPORATE PROFITS

Rising U.S corporate profits provide the other major tailwind for the current bull market run. As Larry Kudlow often quips, “profits are the mother’s milk of stocks”. Several factors help to explain corporate America’s impressive bottom-line performance including: strict labor cost containment efforts, strong global growth, and a weak U.S dollar.

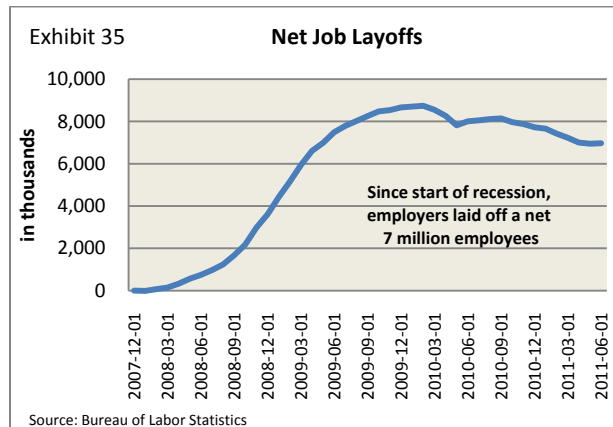
How well has corporate America performed since the start of the U.S recession in December 2007? Well, the numbers speak for themselves. Since the recession started, after-tax corporate profits have *risen* more than 25% (see exhibit 33). Even more impressive, from the quarter in which Lehman Brother’s collapsed (also the cycle low for earnings), profits have risen approximately 130%. Corporate profits now stand at the highest share of GDP since 1950—at 12.6% (see exhibit 34).<sup>28</sup>

<sup>27</sup> Carpenter, S., & Demiralp, S. (2009). Staff working paper from the Finance and Economics Discussion Series. Money, Reserves, and the Transmission of Monetary Policy: Does the Money Multiplier Exist? Retrieved from <http://pragcap.com/your-textbooks-lied-to-you-the-money-multiplier-is-a-myth>

<sup>28</sup> MarketWatch. (Website). (2011) “Corporate Profits’ share of pie most in 60 years.” Retrieved from [http://www.marketwatch.com/story/corporate-profits-share-of-pie-most-in-60-years-2011-07-29?link=MW\\_latest\\_news](http://www.marketwatch.com/story/corporate-profits-share-of-pie-most-in-60-years-2011-07-29?link=MW_latest_news)



Corporate America found several ways to boost the bottom line. First, management reduced overhead costs, primarily through job layoffs. Since the start of the recession, companies laid off a net 7 million employees (see exhibit 35). More worrisome, fewer than 20% of total job losses (since December 2007) have been recovered. While U.S firms reduce domestic headcount, they have been adding jobs abroad. According to the Commerce Department, companies cut their U.S workforce by 2.9 million during the 2000's while increasing their overseas workforce by 2.4 million.<sup>29</sup>



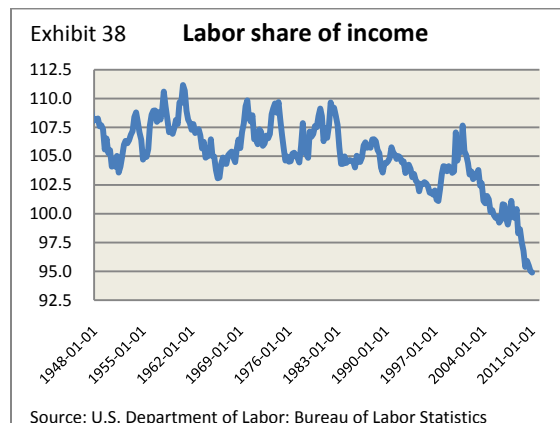
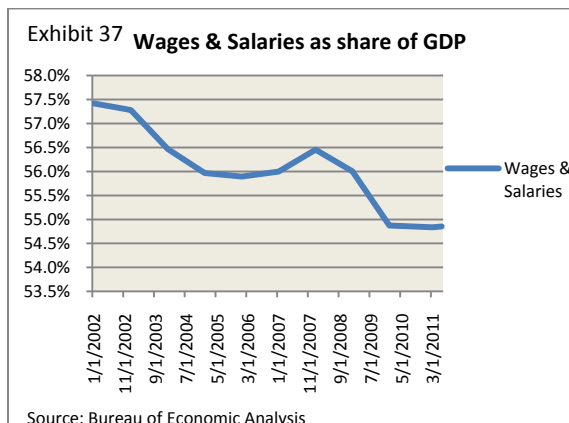
With the advent of global modern communications networks, broadband, and the Internet, more U.S jobs can be performed almost anywhere in the world. Moreover, globalization ushers in labor wage arbitrage. As of 2008, U.S multinational firms could hire a manufacturing worker in China for only \$1.36/ per hour versus a U.S manufacturing worker at \$32.26/per hour. Said another way, a U.S manufacturing employee costs almost 24 times more than the average Chinese manufacturing employee (see exhibit 36). With such a great labor cost discrepancy and companies out to maximize shareholder returns, the incentive exists for jobs to move overseas. Other potential reasons may include creating a new middle class (to

<sup>29</sup> Wessel, D. (2011). "Big U.S. Firms Shift Hiring Abroad." Retrieved from <http://online.wsj.com/article/SB10001424052748704821704576270783611823972.html>

replace a diminishing U.S middle class) for its products and re-locating production closer (to save on transportation costs) to the fast-growing emerging markets.

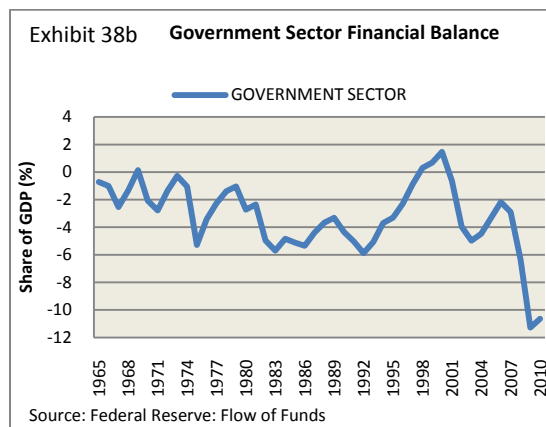
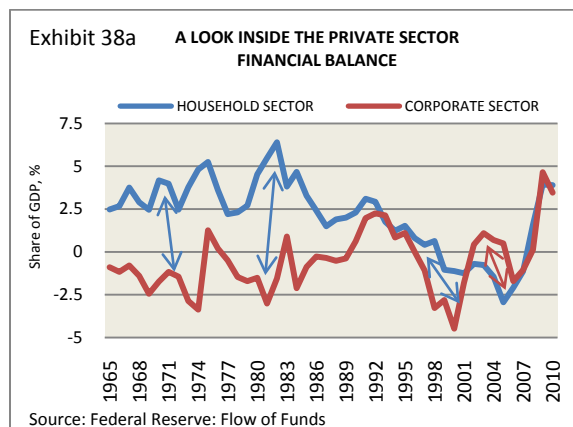


Besides layoffs and outsourcing, companies minimize total labor costs by sharing less of the profits with employees. Even though corporate profits stand at a record high, second quarter 2011 wages & salaries constituted the smallest share of GDP since 1955—54.9% (see exhibit 37).<sup>30</sup> Looking at the same situation from a different perspective, data from the BLS reveals the lowest share of national income ever earned by labor (see exhibit 38). After the brief-run up in labor’s share of income from 1996 to 1998, it has been straight down ever since. This means productivity gains accrued to capital--at the expense of labor. Real labor costs have lagged productivity growth. Historically, economic expansions and tighter labor markets usually see workers claw back some gains.<sup>31</sup> But from 1999-2006, the period during the housing boom, labor failed to share in the fruits of higher productivity and profits. And after the housing bubble burst, creating a slack labor market, employees lost further ground to capital. It may also explain why the household sector failed to report a record surplus balance as a percentage of GDP in 2009 despite a record government sector deficit. The corporate sector surplus has never been higher (see exhibit 38a and exhibit 38b)!



<sup>30</sup> MarketWatch. “Corporate Profits’ share of pie most in 60 years.”

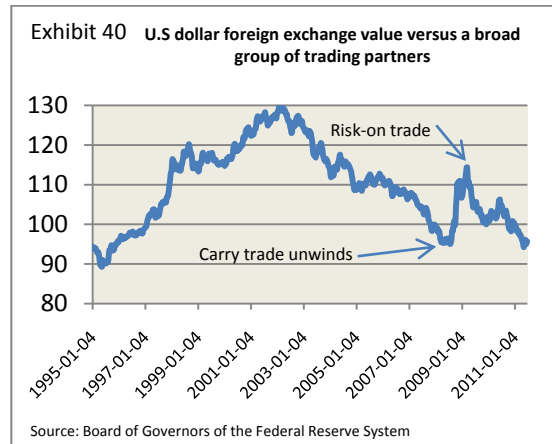
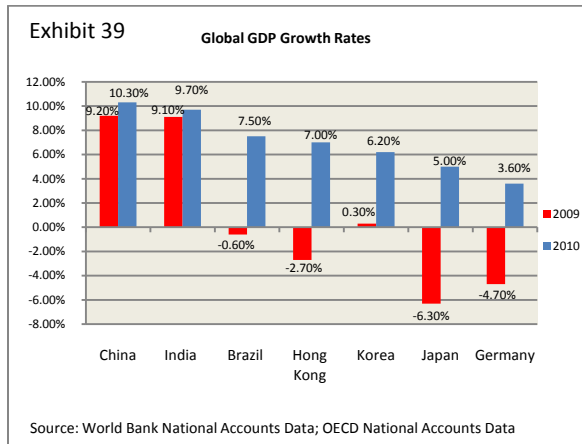
<sup>31</sup> Gomme, P., & Rupert, P. (2004). Measuring Labor’s Share of Income. Retrieved from <https://www.clevelandfed.org/research/policydis/No7Nov04.pdf>



Corporate profits are benefitting from strong global growth too. After a tumultuous 2009 global economic downturn driven in part by the U.S housing crisis, there was a strong rebound outside of the U.S. in 2010. China and India led the way with approximate 10% GDP growth rates, Brazil posted a strong 7.5% figure, and mature economies, Japan and Germany, chipped in as well (see exhibit 39). As a result, many U.S multinational firms experienced strong product demand from the Asia Pacific region and Latin America. This translated into a higher share of foreign sales for U.S multinationals. According to data from Bespoke Investments Group, the average percentage of International revenue for S&P 500 companies in 2009 equaled 29.5%.<sup>32</sup> We assume the figure rose further in 2010 and through the first couple quarters in 2011. Consequently, firms drive record profits despite sub-par product and services demand at home and in Europe.

With relatively unattractive short-term interest rates, a structural current account deficit, QE-related fears of money printing and inflation, and concerns over future debt monetization, the greenback found many detractors. The U.S dollar foreign exchange value against a broad group of trading partners peaked in the first quarter of 2002 and traded lower henceforth, with a brief respite as the carry trade unwound with full force between August 2008 and March 2009 (see exhibit 40). Despite increasing the cost of living for working Americans, the weak U.S dollar positively impacts profits. First, a weak U.S dollar increases the competitiveness of American products in overseas markets. U.S companies end up selling more goods and services to foreign customers. Second, those foreign sales translate back into higher U.S dollar earnings. With the tailwinds of strict cost containment, strong global growth, and a weak currency at their backs, multinationals have produced terrific bottom-line results.

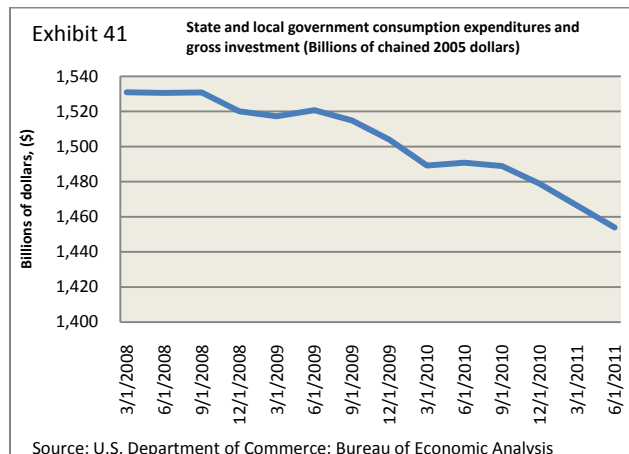
<sup>32</sup> Valetkevitch, Caroline. (2010). "S&P 500 earnings look rosy on 2011 overseas sales." Data retrieved from <http://in.reuters.com/article/2010/12/21/idINN2125476920101221>



**EXIT STIMULUS AND ENTER AUSTERITY**

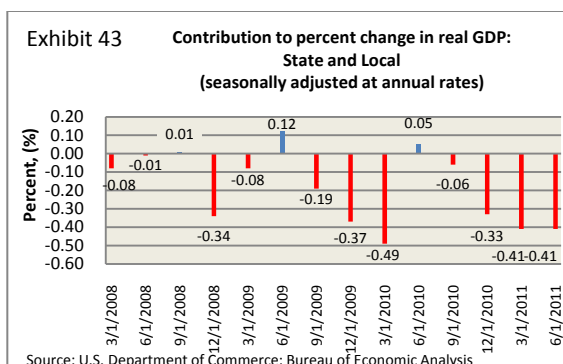
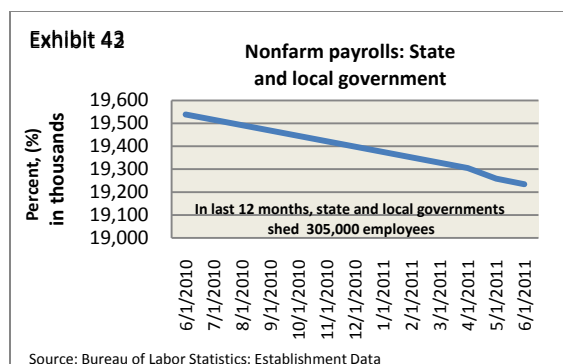
**HEADWIND #1 STATE & LOCAL GOVERNMENTS**

When the property bubble burst and households undertook deleveraging, property and sales tax receipts plunged. State budget surpluses swung promptly to deficits. To achieve a balanced budget status, States turned to a combination of spending cuts, tax hikes, and borrowing. Between the start of 2008 and the second quarter of 2011, inflation-adjusted state and local government expenditures and gross investment sank 5.3% to \$1.45 trillion (see exhibit 41).



Unfortunately, austerity hampers employment and growth. Over the last 12 months, state and local governments shed 305,000 employees (see exhibit 42). More worrisome, despite state budgets being propped up by \$215 billion in ARRA-related federal funding, state and local governments detracted from

overall U.S GDP in 11 of the last 14 quarters (see exhibit 43).



State governments must deal with several challenges, including a sluggish domestic economy and the loss of stimulus funding. Despite these concerns, FY2012 State general fund spending forecasts call for a 2.6% increase relative to 2011.<sup>33</sup> We argue potential spending increases to be premature and sorely mistimed. Even with the modest economic improvement since 2009, budget gaps still persist. According to the National Governors Association and the National Association of State Budget Officers, “Although not all state budget offices have completed forecasts, thus far 33 states are reporting \$75.1 billion in budget gaps for fiscal 2012 and 21 states are reporting \$61.8 billion in budget gaps for fiscal 2013.”<sup>34</sup> With the national economy at risk for double-dip status in late 2012 (more on that later), State budgets deficits are likely to widen. Consequently, State and local governments may be forced into harsh austerity measures at a time of a national recession, intensifying the negative feedback loop for the economy. With Washington locked into an austerity mindset, Federal stimulus (to States) remains off the table until the economy gets much worse. Given these headwinds, we expect state and local government to detract almost 0.75% off of third and fourth quarter 2012 GDP as well as full-year 2013 U.S GDP.

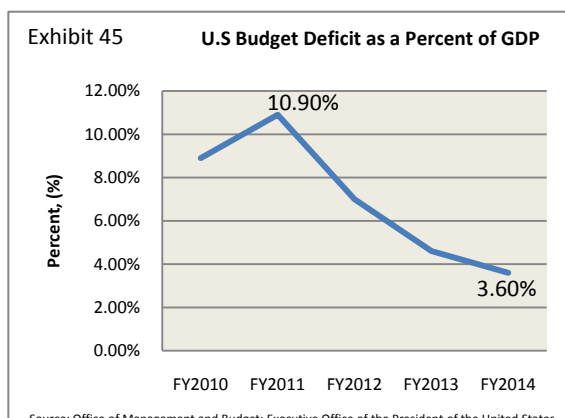
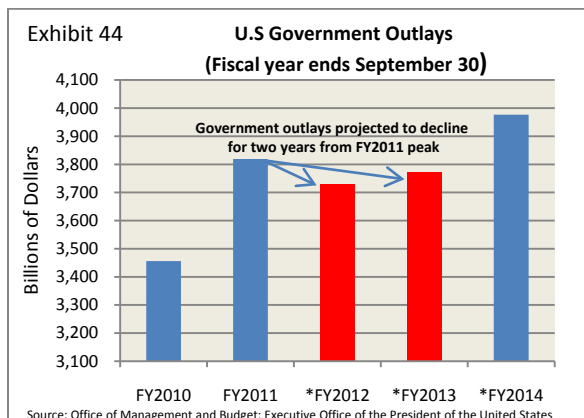
## HEADWIND#2: FEDERAL GOVERNMENT

The U.S government sector poses a major risk to economic growth thanks to the intermediate –term reduction in federal outlays, the signing of the Budget Control Act of 2011, and the withdrawal of previous stimulus efforts. Even before Congress pushed for a deficit-reduction measure in return for raising the debt ceiling, there was already austerity scheduled to take place. For FY2012 and FY2013, U.S government outlays are projected to decline \$90 billion and \$48 billion, respectively, from the peak level of \$3.82 trillion in FY2011 (see exhibit 44). This translates to a spending cut of 2.4% in FY2012 and 1.3% spending cut in FY2013. Given the tighter control on outlays and an expected rebound in budgetary receipts, the White House forecasts the budget deficit to shrink as a percentage of GDP (note: this forecast

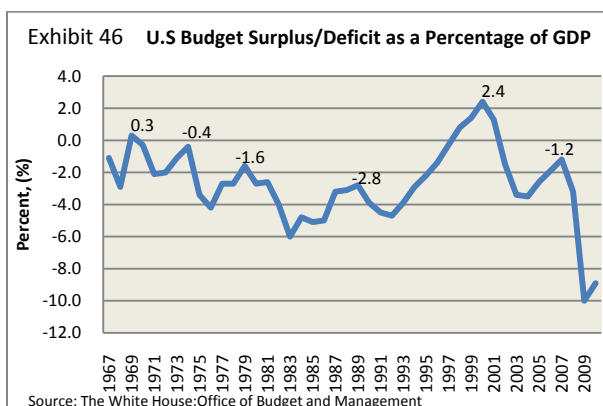
<sup>33</sup> The National Governors Association and the National Association of State Budget Officers. (2011). The Fiscal Survey of States: Spring 2011. Retrieved from <http://www.nasbo.org/LinkClick.aspx?fileticket=yNV8Jv3X7Is%3d&tabid=38>

<sup>34</sup> The Fiscal Survey of States. p. 9.

came before the new Budget Control Act of 2011). The White House forecasts the budget deficit to shrink from 10.9% in FY2011 to 3.6% in FY2014 (see exhibit 45).



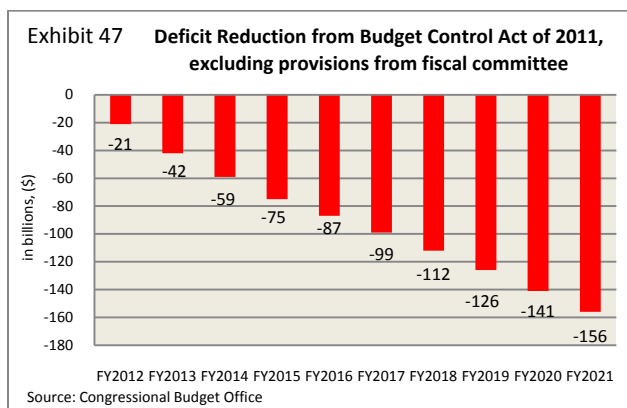
While curtailing deficits may sound nice in theory, in a deleveraging cycle, deflation becomes a major risk. As Richard Koo warns us, “When the deficit hawks manage to remove the fiscal stimulus while the private sector is still deleveraging, the economy collapses and re-enters the deflationary spiral. That weakness, in turn, prompts another fiscal stimulus, only to see it removed again by the deficit hawks once the economy stabilizes. This unfortunate cycle can go on for years if the experience of post-1990 Japan is any guide”.<sup>35</sup> What’s more, U.S history suggests that drastically reducing budget deficits or running budget surpluses results in major economic slowdowns. To argue our point, we created a long-term chart of the U.S budget position relative to GDP and compared it to prior economic cycles (see exhibit 46). There have been 7 U.S recessions since 1962: in the years 1969, 1973, 1980, 1981, 1990, 2001, and 2007<sup>36</sup>. In five of the recessions, a drastic reduction in the budget deficit foreshadowed a contraction, including 1973 (-1.1%), 1979 (-1.6%), 1989 (-2.8%) and 2007 (-1.2%). And in the year 2000, a budget surplus (2.4%) preceded the 2001 recession.



<sup>35</sup> *The Economist*. (Website). (2010). “Is America facing an increase in structural unemployment?” Retrieved from [http://www.economist.com/economics/by-invitation/guest-contributions/no\\_america\\_lacks\\_necessary\\_commitment\\_stimulus](http://www.economist.com/economics/by-invitation/guest-contributions/no_america_lacks_necessary_commitment_stimulus)

<sup>36</sup> The National Bureau of Economic Research. U.S Business Cycle Expansions and Contractions. Retrieved from <http://www.nber.org/cycles.html>

Besides an intermediate-term decline in budgetary outlays, the U.S. also decided to implement a long-term deficit reduction plan. On August 2, 2011, the President signed into law the Budget Control Act of 2011. The bill's major points include enacting a 10-year cap on discretionary spending (2012-2021), increasing the debt limit by at least \$2.1 trillion in a three-step plan, and creating a fiscal committee to find an additional \$1.5 trillion in deficit reduction by November 23, 2011-- and to vote on it by December 23, 2011<sup>37</sup>. If the committee enacts legislation failing to achieve at least \$1.2 trillion in deficit reduction by January 15, 2012, the bill automatically triggers a reduction of up to \$1.2 trillion in government outlays split evenly between domestic and defense spending. So between the upfront \$900 billion of deficit reduction signed into law (see exhibit 47) and the automatic triggers, the baseline for total budget deficit reduction equals \$2.1 trillion over 10 years. On the high side, if the committee does pass a \$1.5 trillion deficit reduction plan, the cumulative budgetary savings end up totaling \$2.4 trillion.<sup>38</sup> While the major spending cuts appear to be back-end loaded, projected savings from discretionary caps still amount to \$60 billion in FY2013, plus the automatic triggers kick in during the same period. Even though the reduction in FY2012 and FY2013 government outlays appear minor as a percent of GDP, this stands in stark contrast to the \$789 billion of cumulative government spending increases in FY2008 and FY2009. With U.S. households mired in a balance sheet recession, we believe premature fiscal consolidation increases the risk of a double-dip recession by late 2012.



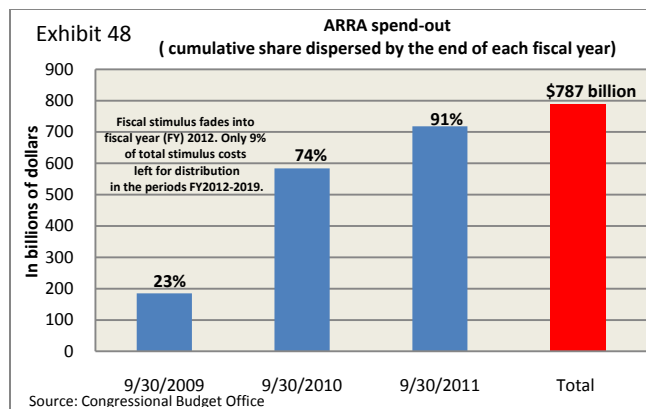
The withdrawal of previous stimulus efforts constitutes another headwind to future U.S. economic growth. First, ARRA begins to fade starting in FY2012. Of the original \$787 billion price tag, only 9% of total stimulus costs remain left for distribution in the periods FY2012-2019. (see exhibit 48). From the start of the program in February 2009 to late September 2011, the U.S. Government paid out approximately \$664.2 billion, or more than 84% of ARRA-related stimulus funding<sup>39</sup>. By the end of FY2011, we expect approximately \$674 billion of total stimulus funding to be paid out. Unfortunately, this leaves only \$42

<sup>37</sup> The White House. (2011). Fact Sheet: Bipartisan Debt Deal: A Win for the Economy and Budget Discipline. Retrieved from <http://www.whitehouse.gov/fact-sheet-victory-bipartisan-compromise-economy-american-people>

<sup>38</sup> Congressional Budget Office. CBO Analysis of August 1 Budget Control Act. Retrieved from <http://cbo.gov/ftpdocs/123xx/doc12357/BudgetControlActAug1.pdf>

<sup>39</sup> Recovery.gov (website). Breakdown of ARRA stimulus retrieved from: <http://www.recovery.gov>

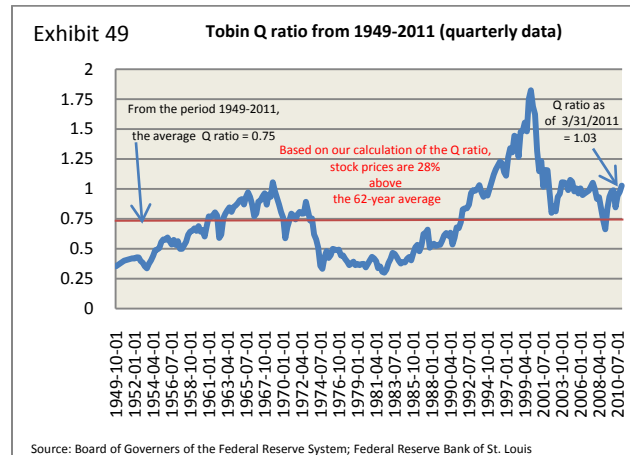
million in ARRA spending in FY2012, down from our FY2011 estimate of \$120 billion. As a result, we expect ARRA to detract almost .4% from 2012 GDP.



Second, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (H.R. 4853) has certain provisions expiring in FY2012. The recently passed Budget Control Act of 2011 failed to include an extension of the one-year payroll tax holiday (\$112 billion), unemployment insurance (\$56 billion), and investment incentives (\$22 billion). For FY2012, the loss of stimulus from H.R. 4853 totals approximately \$190 billion. Combined with the loss of ARRA stimulus funding (\$78 billion), we expect the U.S economy to lose net stimulus of approximately \$268 billion. Given the intermediate-term reduction in federal outlays, the spending caps from the Budget Control Act of 2011, and the withdrawal of previous stimulus efforts, we expect fiscal consolidation to subtract approximately 2.5% from 2012 GDP.

### THE HANDOFF FROM THE PUBLIC TO THE PRIVATE SECTOR

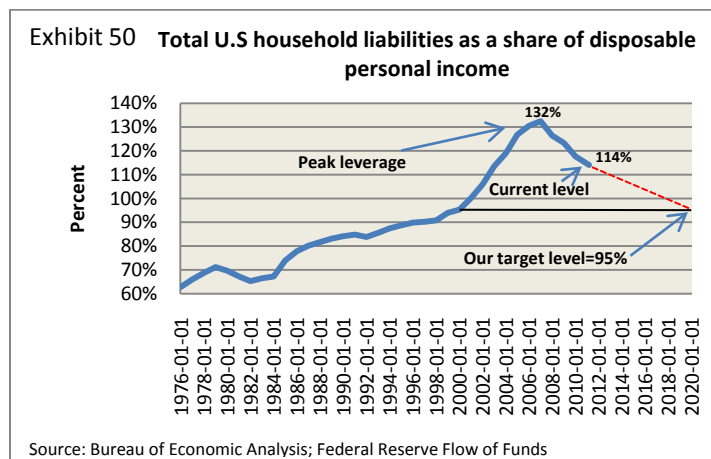
After several years of the public sector shoring up the U.S economic and financial system by running higher budget deficits, the training wheels come off and the question becomes; can the private sector lead us into a self-sustaining recovery with fiscal austerity looming on the horizon? Essentially, the baton gets passed from the public to the private sector. With the stock market priced at a 28% premium to its 62-year average, financial markets have yet to discount the risk of a fumble in the exchange (see exhibit 49). As we learned from the Japanese experience of the 1990's, private sector deleveraging must end before it can lead an economy into a self-sustaining recovery. Any attempt at fiscal consolidation plunges an economy into deflation. Will it be different this time? Can the U.S consumer offset a potential -2.5% loss to 2012 GDP from fiscal austerity?



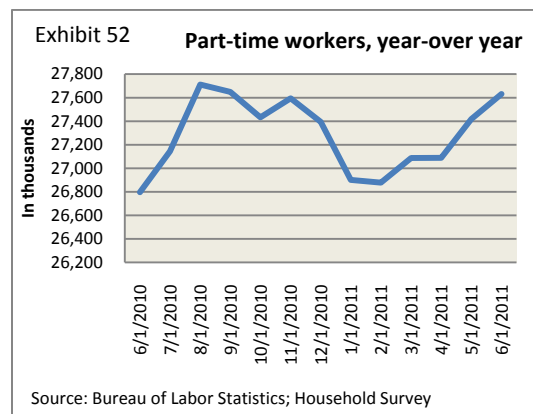
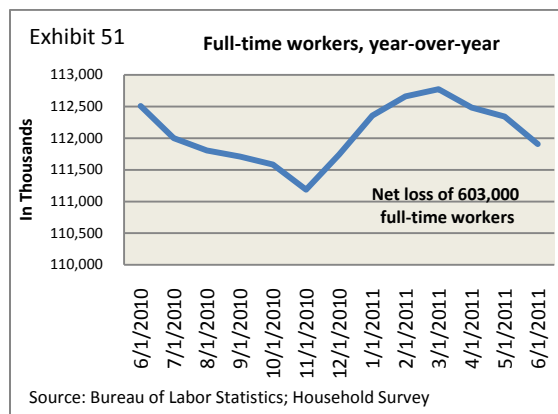
### HEADWIND #3: HOUSEHOLDS

We believe U.S households will be unable to carry the baton thanks in part to further deleveraging, a weak labor market, and sluggish disposable personal income growth. First, U.S households still carry too much leverage relative to historical levels. Using the Japanese experience as a guide, household deleveraging remains far from over. From the bubble peak to the year 2001, Japan's non-financial firms reduced their leverage ratios by 30%. If we use household liabilities as a share of personal disposable income as a comparable metric, U.S households would be only 60% of the way through the deleveraging process. But we assume household leverage returns back to where it stood in the year 2000, which translates to the initial phase of the debt-financed U.S housing bubble.

So where do U.S households stand in the deleveraging cycle? Up to this point, U.S households have taken their leverage ratio down from the peak of 132% in 2007 to 114% by the first quarter of 2011 (see exhibit 50). To reach our target level of 95%, with an assumption of no disposable personal income growth in 2012 and 2013, and 1% growth in 2014 thru 2020, total household liabilities would need to decline \$150 billion on an annual basis between 2012-2020. In the near-term, we expect household deleveraging to reduce personal consumption expenditures by 1% in 2012 and 2013.

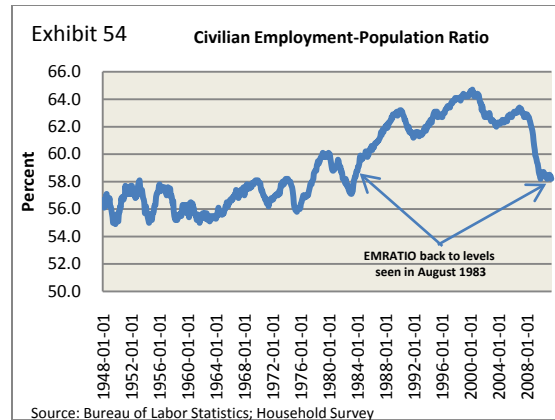
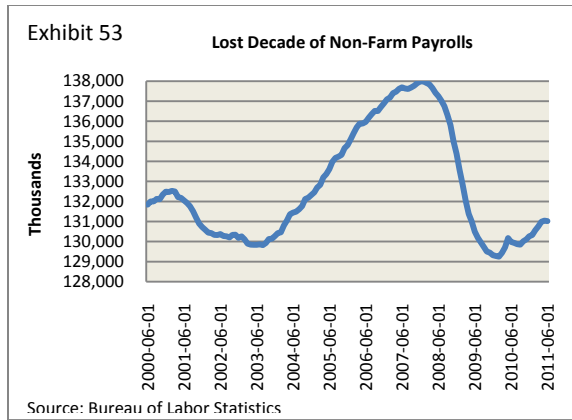


The labor market acts as another constraint to a U.S household-driven recovery. While the stock market may have recovered well of the 2009 lows, the employment situation shows no real signs of improvement. Let’s take a look at the numbers. In the last 12 months, the U.S workforce lost a net 603,000 full-time workers (see exhibit 51). And in its place, the U.S workforce added a net 835,000 part-time workers (see exhibit 52). Essentially, U.S companies decided to eliminate full-time employees with benefits and add part-time workers with lower pay and fewer benefits. After taking a gander at these two charts, is anyone surprised consumer confidence continues to erode?



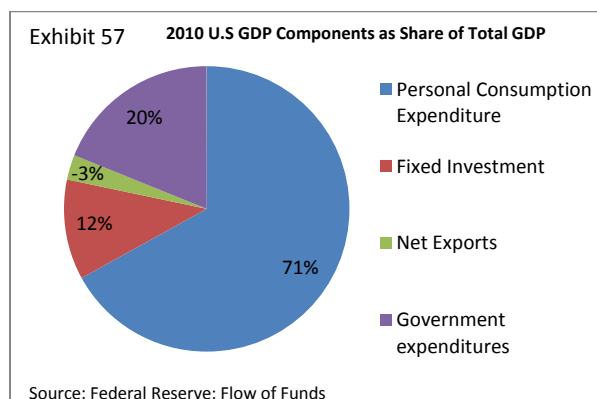
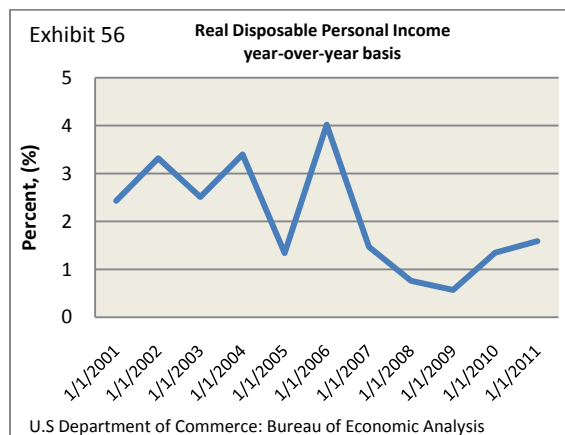
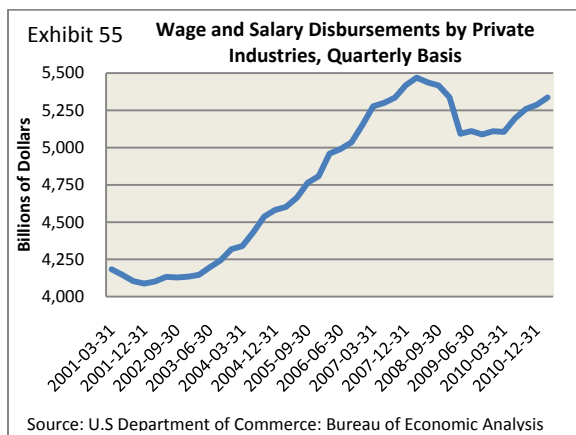
What’s more, the long-term employment picture reveals a lost decade of non-farm payrolls. In June of 2001, total non-farm payrolls totaled approximately 132 million. Ten years later, in June of 2011, there were only 131 million non-farm payrolls (see exhibit 53). In one decade, the U.S economy added 1 million fewer non-farm payrolls. The Civilian Employment-Population Ratio shows long-term labor market deterioration as well. In June of 2011, the Civilian Employment-Population Ratio (EMRATIO) came in at 58.2. To put it into perspective, EMRATIO is back to levels last seen in August of 1983- more

than 27 years ago (see exhibit 54).



With lackluster job growth and the apparent shift to part-time employment, employees lack the income growth to drive consumer spending. Private sector wage and salary disbursement remain well below the peak level (see exhibit 55). In the most recent quarter ending March 31, 2011, wages and salary disbursement by private industries declined by approximately \$133 billion, compared to same period in 2008. Moreover, real disposable personal income (which is income after taxes and inflation), has been in a steady downward trend since 2006 (see exhibit 56). With the potential expiration of the payroll tax cut holiday at year-end eroding after-tax income, further weakening in the U.S economy holding down nominal wages, and the fear of QE3 maintaining a bid under commodity prices, we expect real disposable personal income to be flat in 2012 and 2013. This puts more than 70% of GDP at risk (see exhibit 57).

For the full year 2012, we anticipate a 1% reduction in personal consumption expenditures. The other major contributor to GDP, government expenditures, is also set to detract from economic growth. Less government and household spending means fewer dollars for Corporate America and for our largest trading partners. With more than 90% of GDP in contractionary mode, the U.S is likely to be in a recession by the fourth quarter of 2012.



### CONCLUSION

The U.S economy remains mired in a balance sheet recession. Up to this point, the U.S government applied the necessary fiscal stimulus to offset private sector deleveraging. But with worries surfacing about the growing public debt, policymakers now choose to unwind the stimulus and enact austerity. Unfortunately, history teaches us that curtailing budget deficits prior to the end of a balance sheet recession leads to a deflationary recession. This time is no different. We expect the U.S economy to be in a double-dip recession by the fourth quarter of 2012. Investors may want to exit the side door left.

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