



US Vital Statistics

April 2010

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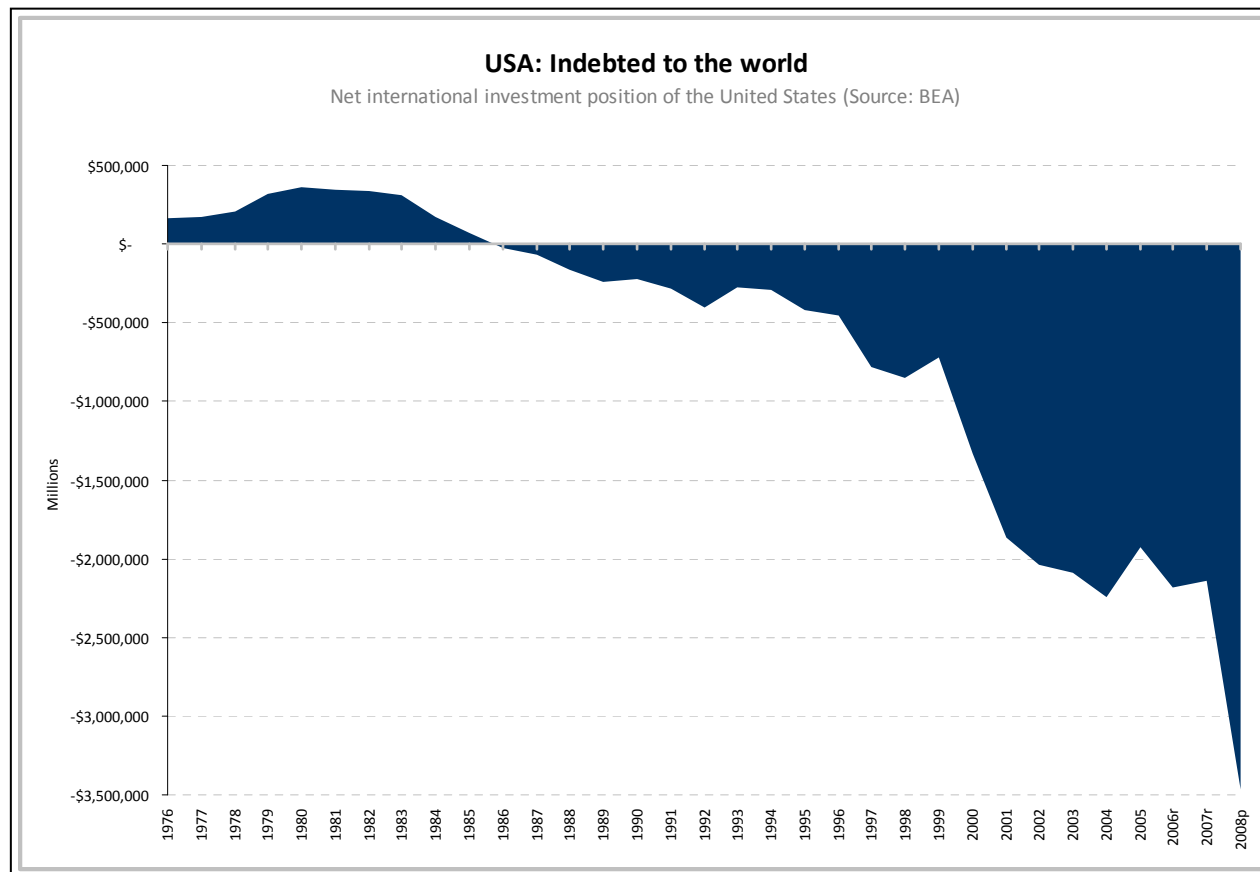
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USA is indebted to the world

- we owe more than we own -

Conventional wisdom suggests:

growing reliance on foreign capital = higher cost of capital (or even a funding crisis)



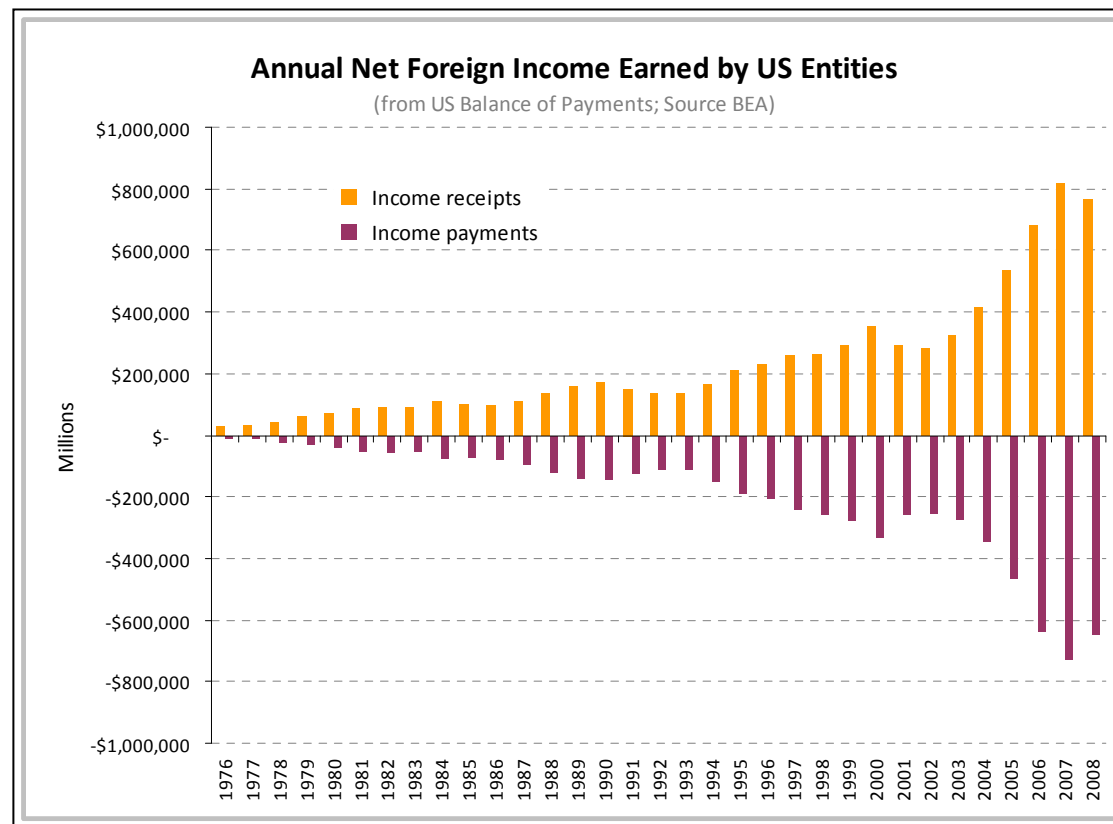
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Yet foreign income exceeds foreign payments

- *the exorbitant privilege of reserve currency status* -

Reserve status keeps US risk and liquidity premia low, reducing cost of capital relative to foreign entities.

How long can this imbalance last?



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Is a US sovereign debt crisis inevitable?

- again, reserve currency status alters the odds -

- All things equal, any entity that must borrow to spend will eventually hit a funding crisis. As lenders disappear, a country is forced to borrow at higher yields and/or print money to finance expenditures.
- As the world's favoured trading and reserve currency (because the US is the world's biggest consumer, has the world's deepest/most liquid risk-free asset market and has the world's strongest military) the US may be an exceptional case. Consequently, the US can theoretically manage bigger deficits than other country.
- While the direction of US public debt and deficits is worrisome, and the probability of a US debt crisis is rising, the probability of a US debt crisis is not yet 100%.
- The following historical illustration demonstrates how actual events can often defy conventional logic.

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1930-1945: Chapters of a debt crisis?

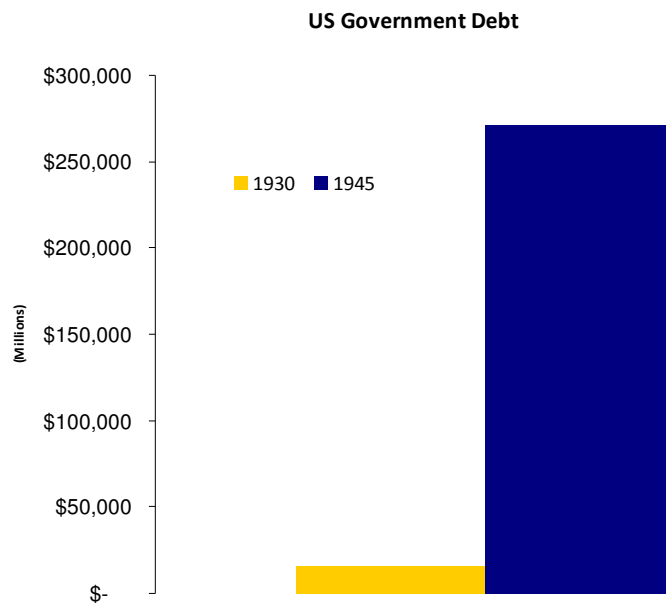
- *economic output / recovery increasingly reliant on debt...sounds familiar?* -

During the mid-1930s people were worried about deficits/debt.

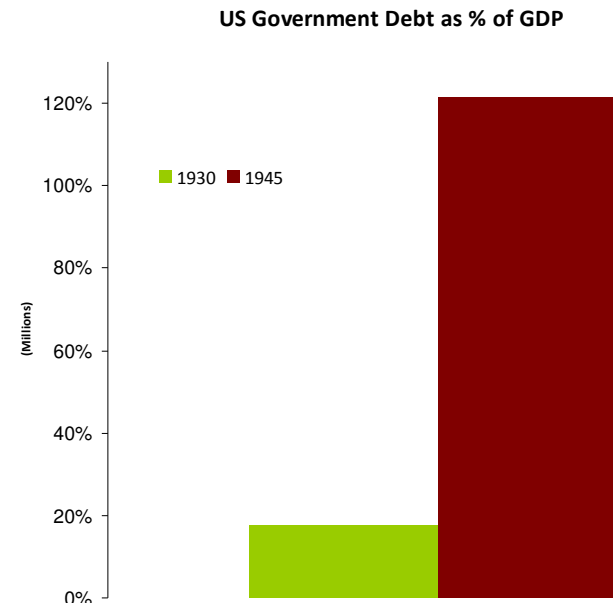
Imagine how they felt as debt levels continued to skyrocket...

...and this was a time when the US dollar did not benefit from an exorbitant privilege.

Public Debt Up 1574%



Public Debt to GDP Up 584%

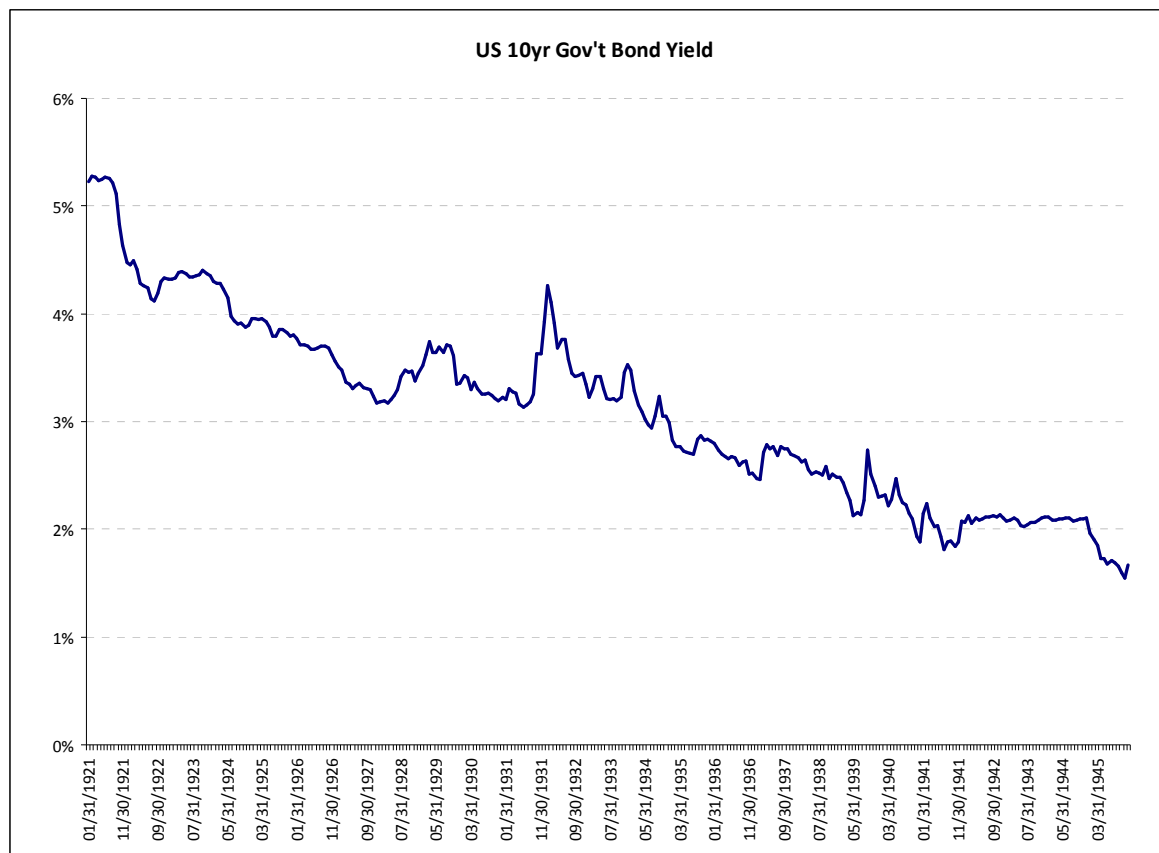


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1930-1945 was actually, a Treasury bull market

- *bond yields declined !?! conventional wisdom be damned* -

The 1930-1945 situation is clearly not identical to today.
However, it illustrates how a widely-expected outcome can be quite distant from reality.



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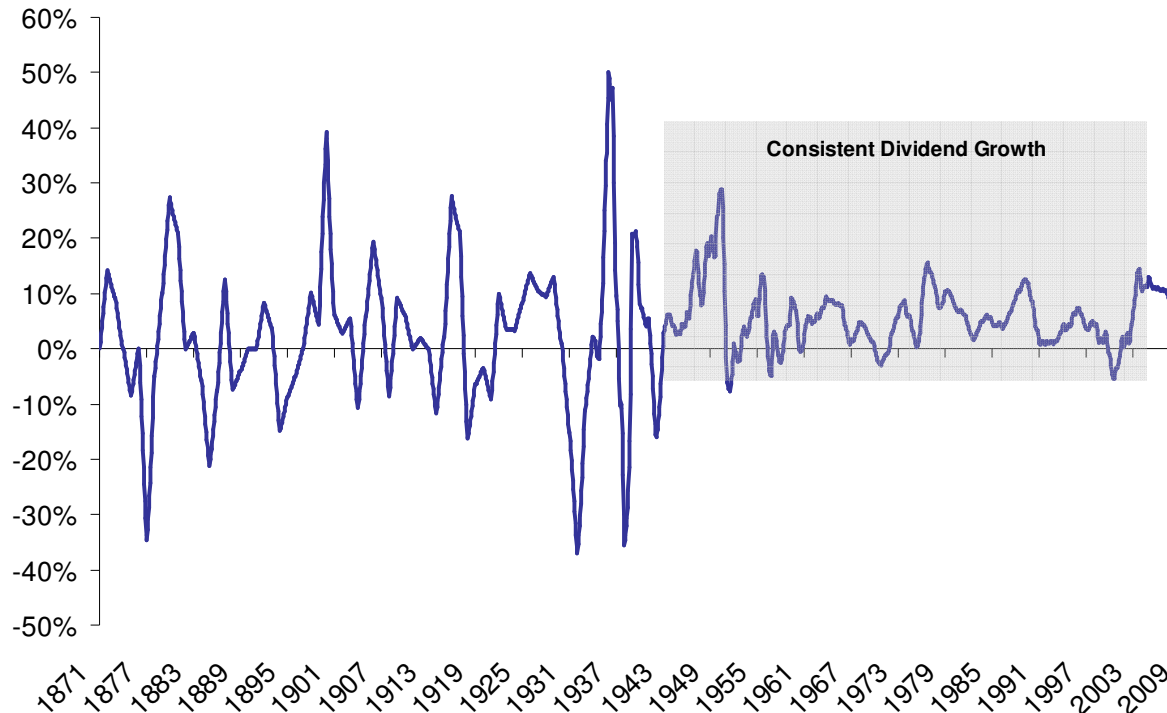
1945: What came next?

- *After the Depression and War, an era of new stability seemed improbable* -

Conventional wisdom fails yet again as the US enters an new era of prosperity, despite millions of unemployed soldiers and massive government debt. Again, 1945 is not the same as today...but never underestimate the unexpected.

Manufactured Comfort: *Post-War Dividend Stability*

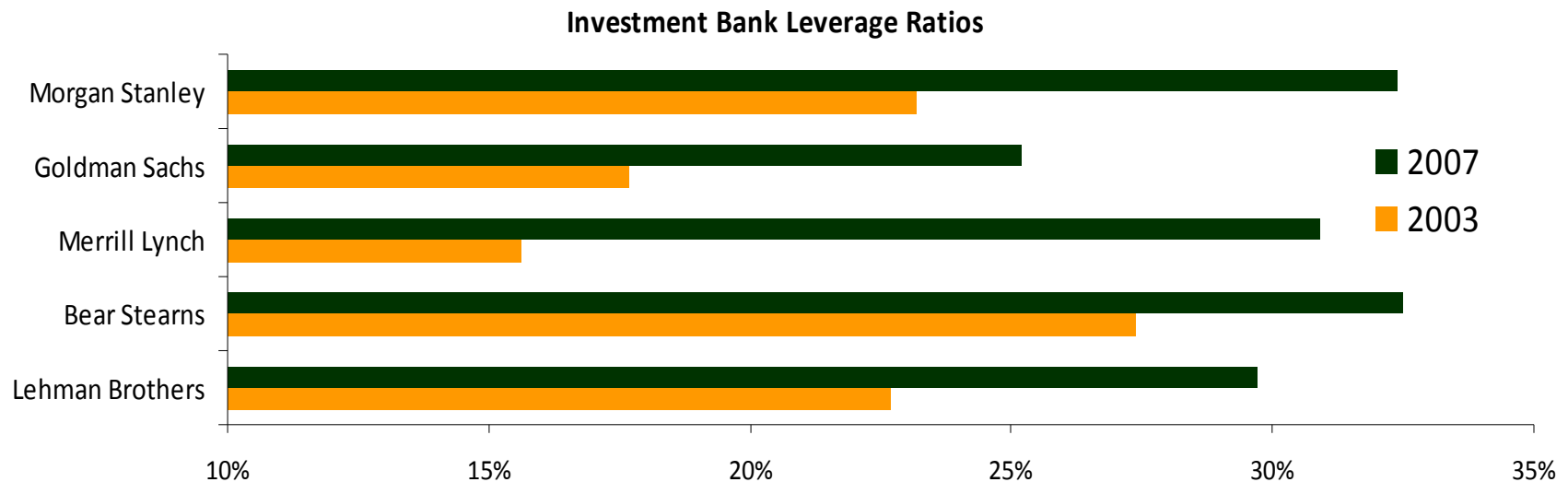
Rolling 12mth Growth in S&P 500 Dividends



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What does 60yrs of stability get you?

- massive build-up of systemic risk, all-asset bubble and a massive financial crisis -



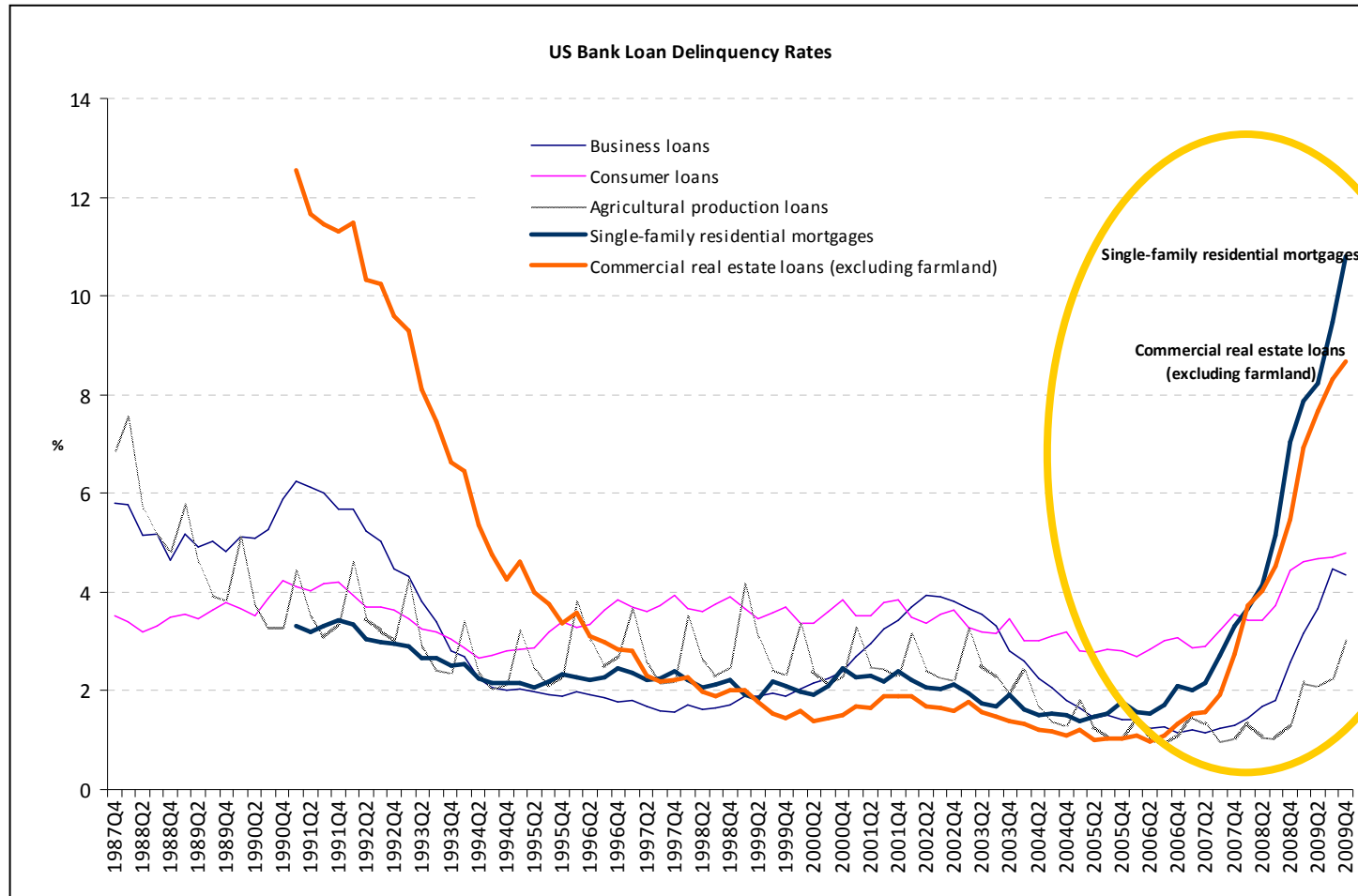
After 60+ years of relative stability, a financial collapse seemed improbable. So as developed economies reached capacity and return on capital shrank, investors took more risk to enhance returns.

But we eventually got our 'Minsky moment'.

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Real estate loans collapsed

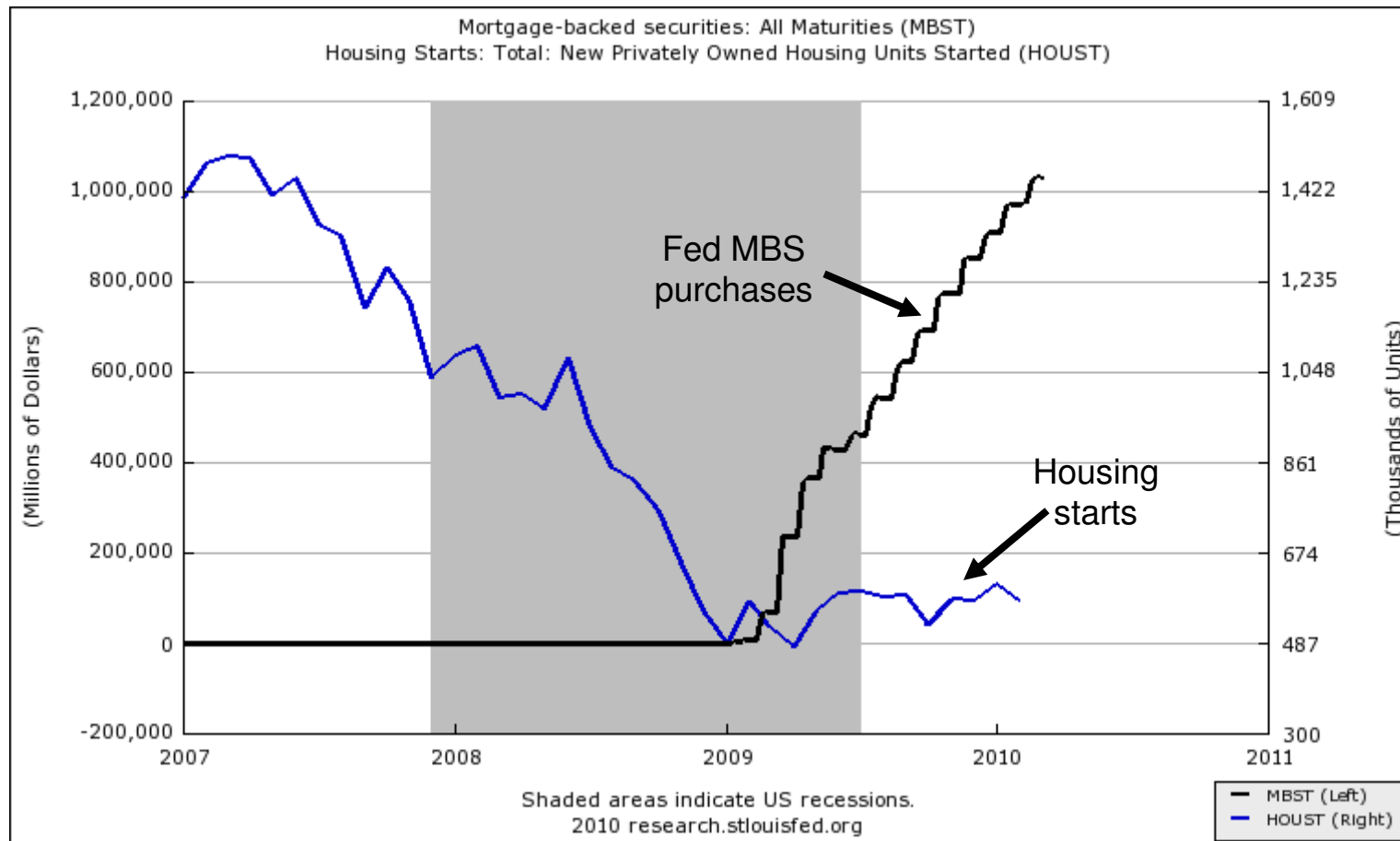
- declining real estate prices led to implosion of levered entities -



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Saved by the Bernanke put

- MBS purchase program puts floor under housing market -

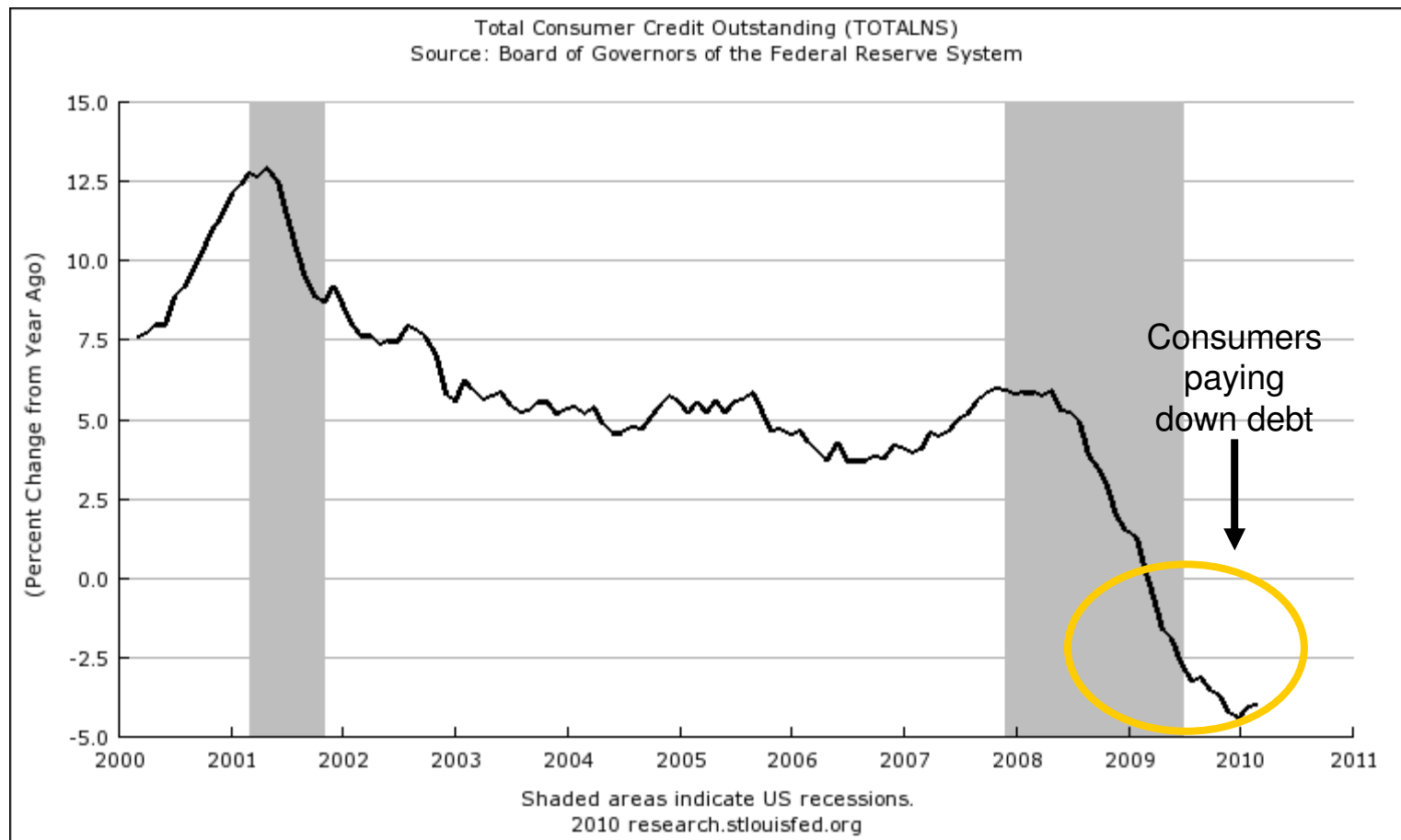


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A new attitude: Consumer credit declines

- personal deleveraging reflects a new frugality -

Today's consumption replaced by tomorrow's savings.



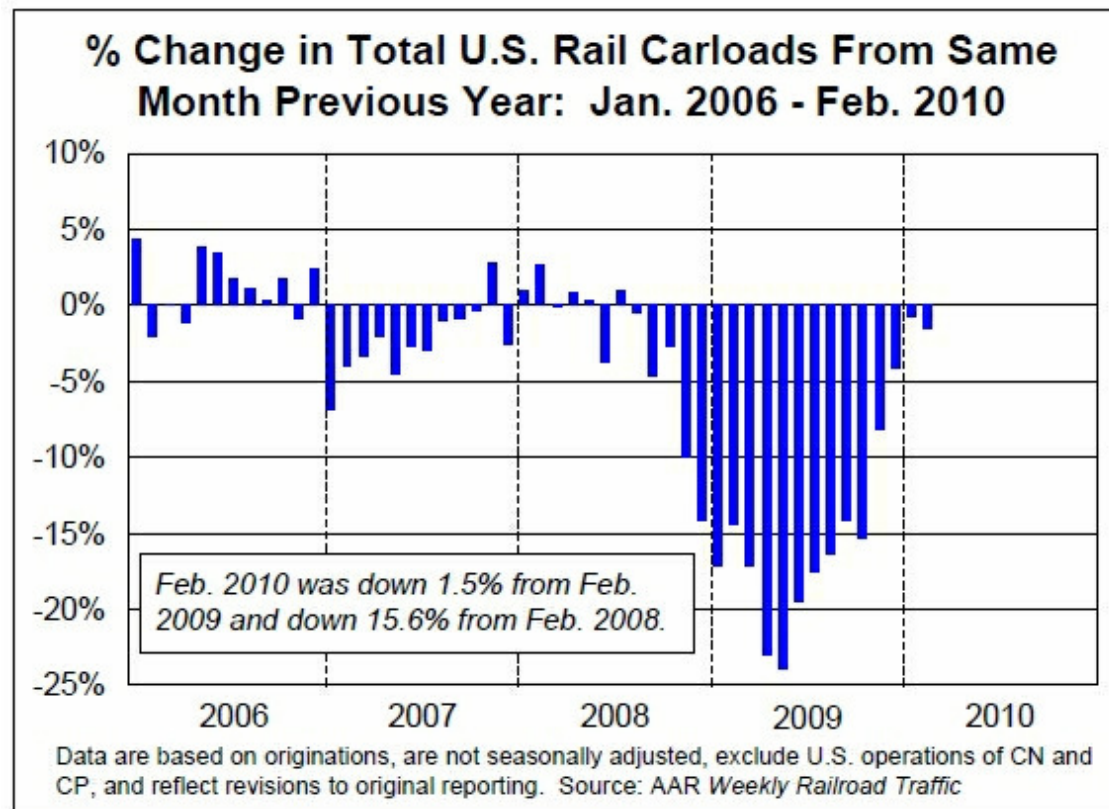
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US industry has stopped bleeding

- lower operating levels reflect consumer deleveraging -

US rail traffic stable but still in ICU.

Eventually, a stable consumer will prompt a more robust return to industrial activity

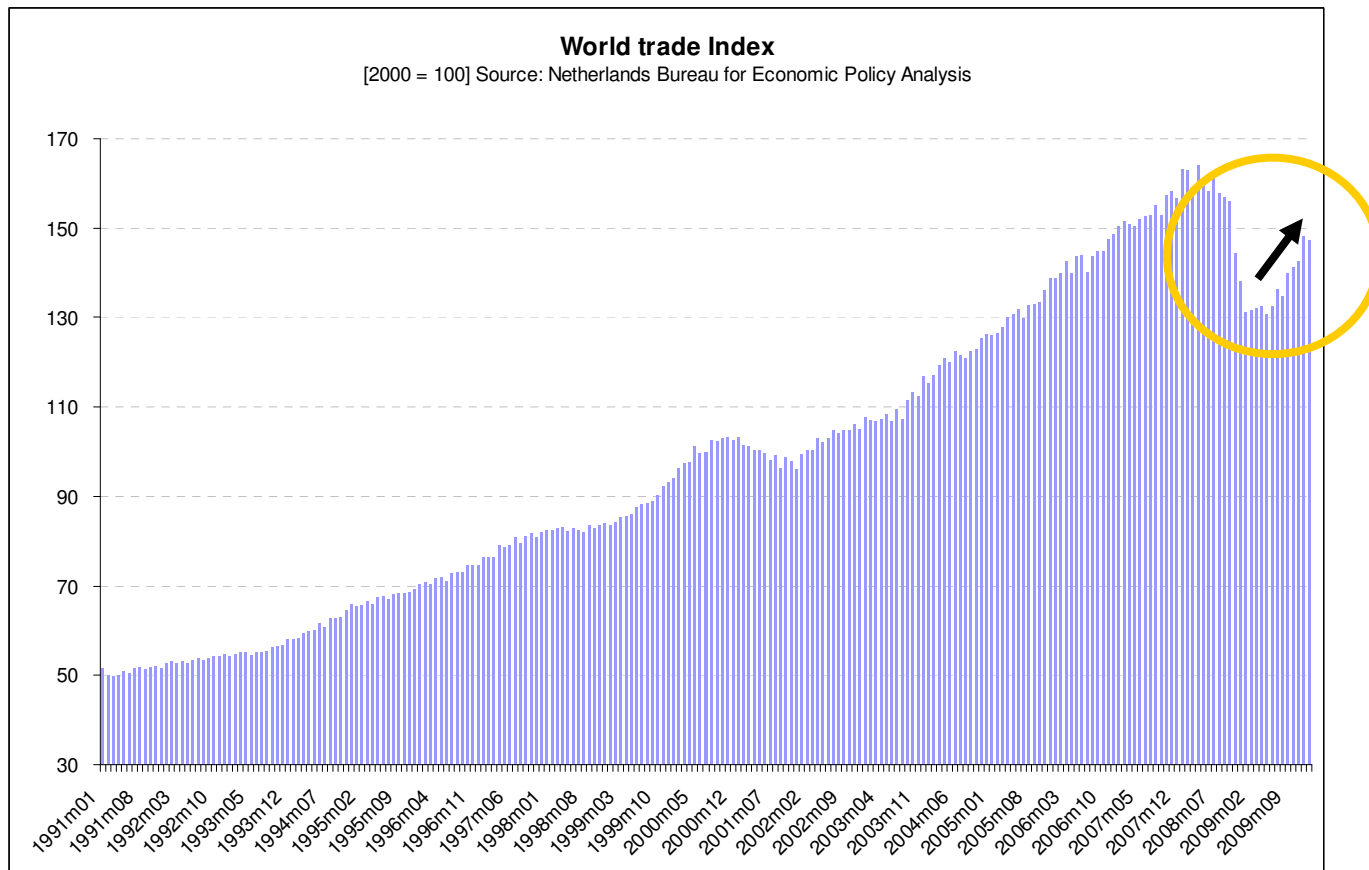


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Foreign demand stepping in for the US consumer?

-world trade back to 2006 levels -

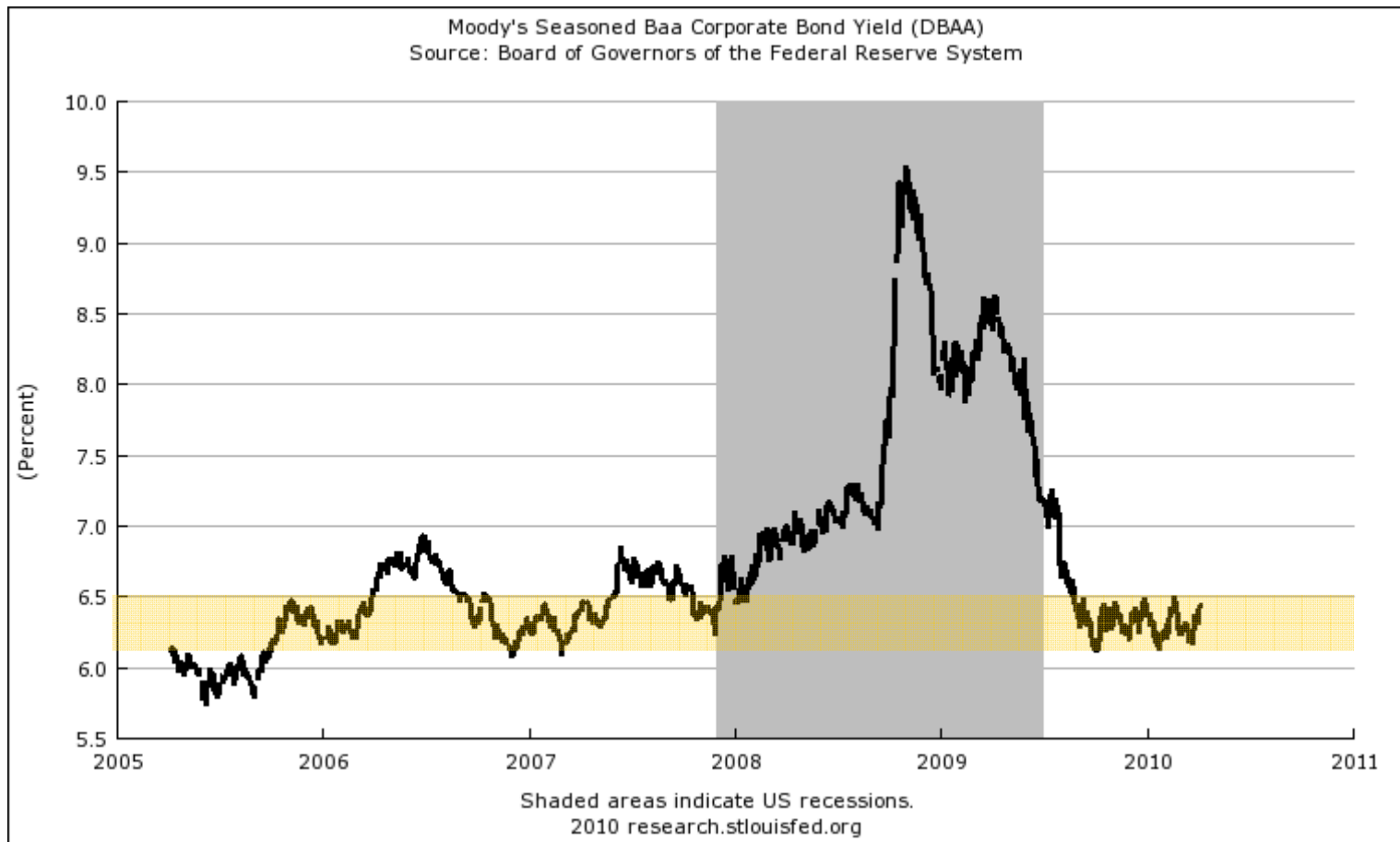
BRICs and commodity producers leading the charge



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...and global investors are hungry for US assets

- back to 'normal'...US companies can affordably access capital markets -

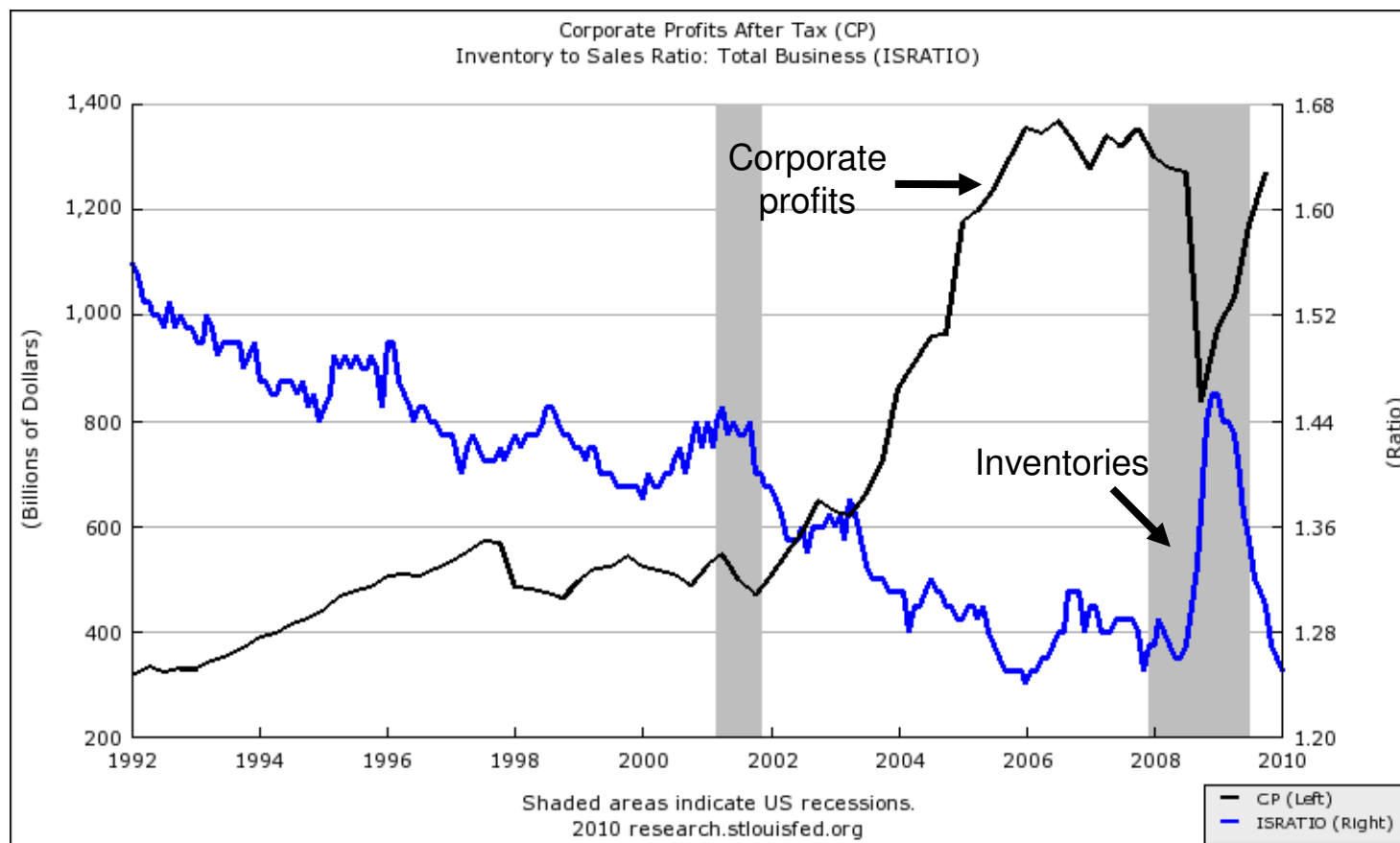


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So, US companies doing fairly well: strong profitability

- profits and inventories nearly back to pre-recession levels -

Unfortunately for many, businesses have learned to operate with fewer employees so hiring will be slow. However, in the long-run this is good if unemployed are re-deployed to more productive industries.

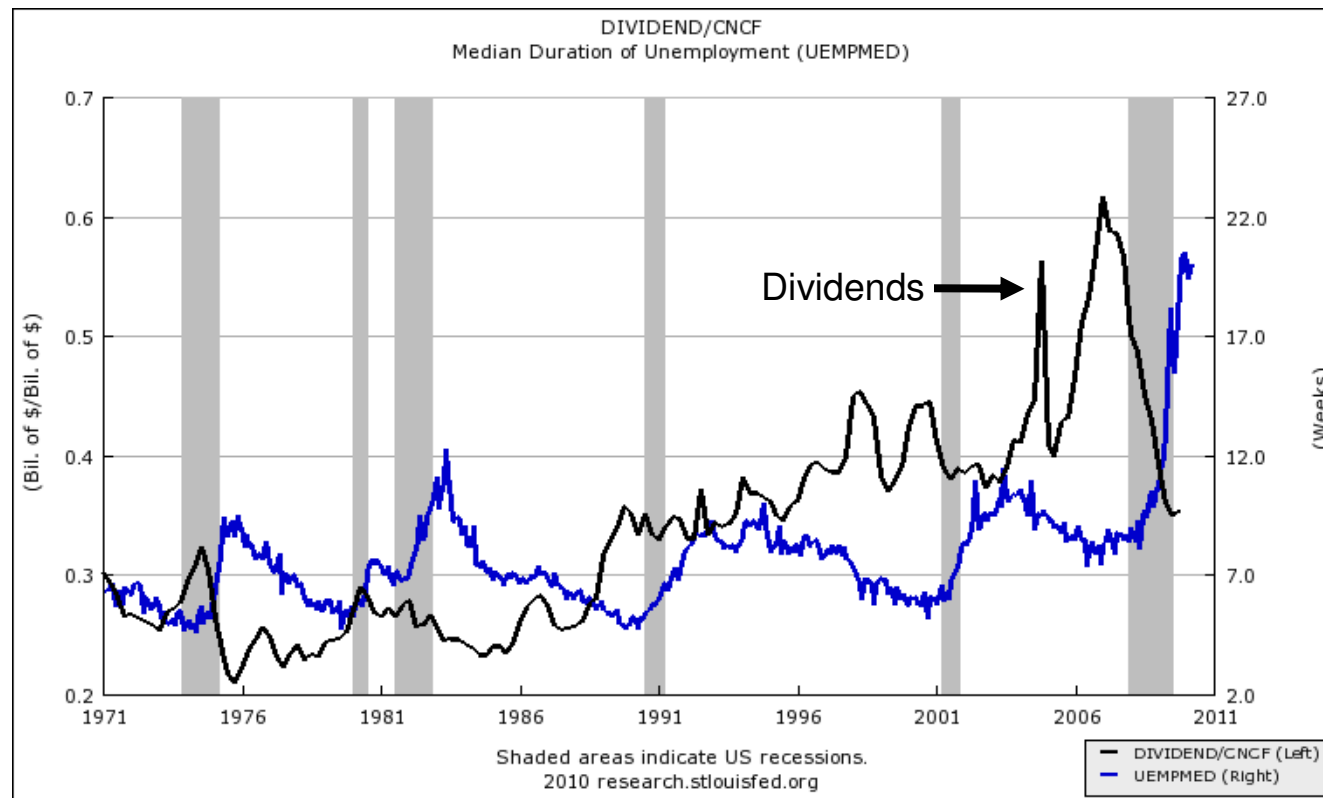


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Dividends have troughed: Profit retention = giant cash-build

- eventually, dividend increases will confirm management belief in sustainable recovery -

Dividend increases are 'sticky' (i.e. management doesn't like to cut dividends).
Therefore, dividend increases tend to be made when management is confident about the future.
* Confidence also makes managers more willing to re-hire workers *



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So what will companies do with cash?

- cash is king...for now -

- Some may pay dividends
- Some may buy other companies
- Some may hoard cash
- Some may pay down debt
- Finally, some may hire workers

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Bottom Line: conventional wisdom suggests a funding crisis (which could seriously damage the US economy) will be a consequence of today's growing US public debt. This logic is difficult to argue against, but history – specifically, the Great Depression - suggests a US debt crisis is not a foregone conclusion.

{Note: Conventional wisdom also argued that a financial crisis was improbable.}

Meanwhile, the US economy appears to be in the midst of a full-blown jobless recovery. Corporate profits have recovered off the backs of the unemployed. When corporate profits will lead to employment gains is debatable. Realistically, hiring new staff will be the last thing companies do with their cash hoards.

Alternatively, under-capacity in certain industries may offset overcapacity in others, enabling a structural redeployment of workers. However, this may be a drudgingly slow process.

{...or we could just jump headfirst into the next bubble.}

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