



Our Steroidally Challenged Economy

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November 17, 2009

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Birds are singing, the sun is shining and life is beautiful again. On the surface, the vital signs of our economy are improving with every economic report. In some areas, like unemployment, the rate of decline is decelerating; in others, like GDP, decline is turning into growth. The stock market is behaving as if the history of the last twenty years is about to repeat itself: recession will turn into a robust expansion. Stock prices are discounting an expectation of robust earnings recovery to a level only slightly below the pre-financial crisis level, and risk taking is in vogue again as the performance of junky stocks trumps quality.



The global economy reminds me of a marathon runner who runs too hard and hurts himself. But now he has another race to run. So he's injected with some serious, industrial-quality steroids, and away he goes. As the steroids kick in, his pace accelerates, as if the injury never happened. He's up and running, so he must be ok; this is the impression we get, judging from his speed and his progress.

What we don't see is what is behind this athlete's terrific performance – the steroids.

Of course, we can keep our fingers crossed and hope that the runner has recovered from his injury and what we see is what we get – the athlete is at the top of his game – but there are problems with this thinking. Serious steroid intake comes at a cost: it exaggerates true performance. Steroids can be addictive; once we get used to their effects it is hard to give them up. The longer we take them the less effective they are. Finally, there is a good reason why steroids are banned in sports: they damage the athlete's body.

Our economy suffered severe injuries last year, and to keep it going massive amounts of steroids were and are being injected – they're what economists call stimulus (or government intervention).

Let's take a closer look at the extent of the steroidization (to coin a new word) of our economy, and its side effects.



I'll focus on the US economy, but similar arguments to varying degrees are true for many countries around the world. In the US, things appear to be stabilizing and improving on the surface, but beware, there is a giant IV hooked up to the veins of the economy, through which billions of dollars are constantly being pumped in. The stimulus is everywhere:

- To help the auto industry taxpayers were subsidizing the price of autos through the “cash for clunkers” program and thus were creating artificial demand. In addition, GMAC is to receive a third government bailout. So far taxpayers have pumped \$13.5 billion into GMAC.
- The housing market, the epicenter of this crisis, is propped up from different directions. On one side there is a buyer (it used to be the just first-time buyer, now it is any buyer) tax credit. From a different direction interest rates are kept low by the Fed’s quantitative easing, fancy econ-speak for the Federal Reserve buying long-term bonds and thus keeping long-term rates artificially low. Finally we have the (now) defunct government-controlled Fannie and Freddie, which *are the mortgage market* of our economy, since they account for the bulk of mortgages originated today.
- Since banks are the conduits through which the government pumps stimulus into the economy, the aforementioned government involvement in the housing market helps them generate enormous fees. In addition, profitability is boosted (at the expense of savers) by the near zero short-term interest rates, again thanks to the friendly Fed, that allows banks to earn a healthy interest-rate spread.
- Last, and certainly not least, the giant, multi-hundred-billion-dollar infrastructure projects are coming on line as you read this. Yes, steroided we are.

Now let’s look at the side effects:

- Our economy’s true, unsteroided, unstimulated performance is a lot lower than the one we observe. Though the government can spend money at a high rate for longer than one would rationally expect, stimulus is a finite endeavor that comes with a heavy price tag. In most cases the stimuli have been financed with higher future taxes and rising government debt, thus higher future interest rates.
- Steroids and stimulus share addictive properties, and the longer we take them the less effective they become; but once we’re used to them it’s hard to give them up. The \$8,000 tax credit started as a temporary measure. However, the politicians found it difficult to let go, and the program was extended and



supersized by providing the tax credit to anyone with the patriotic ambition to buy a house.

Japan was on the stimulus bandwagon for more than a decade and, with the exception of its government debt-to-GDP ratio tripling, Japan has nothing to show for it. Their economy is mired in the same rut it was in when its stimulus marathon started. It had a hard time giving up stimulus because the short-term consequences were too painful. Also, Japan is proof that a low (zero) interest-rate policy loses its stimulating ability over time and turns into a death trap for the economy as leverage ratios are geared to low interest rates. Now, even a small increase in interest rates (say, from 1% to 2%) would be devastating for Japan's economy.

In many cases the stimulative measures just accelerate future sales to an earlier date, at the taxpayer's expense. After "cash for clunkers" ran its course, demand for autos fell into the abyss. The same will be the fate of industries exposed to infrastructure projects.

- Finally, stimuli result in long-term damage. Politicians and central bankers have good intentions; they hope that the stimulus will tide us over the bad times and buy some time for the economy to heal itself. It's a logical argument. For instance, as much as we hate banks to be making a lot of money today, it allows them to patch up holes in their balance sheets from past and future losses.

However, for the most part stimuli just kick the can down the road and result in higher debt and higher taxes. But the harm doesn't stop there: stimuli cause bubbles. The fix for the 2002 recession involved interest rates staying at extremely low levels for a long time, which resulted in the housing/liquidity bubbles we're paying for today. The present stimuli will leave us with even more serious damage somewhere down the line.

The stock market's recent rally followed a typical, by-the-book, coming out of recession trajectory – it was cyclical. The stocks most sensitive to the economy appreciating the most.

Let me demonstrate what is priced into cyclical stocks by looking at Caterpillar (CAT) – your typical American blue chip industrial, cyclical stock – one that in theory should prosper during global economic recovery.

Third-quarter sales were down 44% from last year. China was its brightest spot as sales there dropped (only) 26%. The stock is around \$60, more than double its low in March and not far from \$85, its all-time high, reached in 2008 when global growth was its oyster. The company expects to earn around \$2 this year (excluding recurring



nonrecurring charges) and expects sales to grow in teens next year from this year's base. But even if CAT were to earn \$3 next year, investors are not paying for next year's earnings, as they'd be paying 20 times next year's earnings.

This cyclical stock is not worth that; investors are paying for what happens beyond 2010.

To understand what happens past 2010, let's see what is driving CAT's next year's earnings growth. Here is a quote directly from a CAT press release: "[Global] Governments introduced more than \$3.5 trillion in multi-year stimulus programs with most of the expected impact in the last half of 2009 and into 2010."

If I owned CAT, the question I'd want to know the answer to is, what's next after 2010?

Stimulus creates an appearance of stability and growth, but a lot of it is teetering on a very weak foundation of government intervention. Investors must distinguish between what is real and what is not; in this environment, investment success will not only depend on what stocks you own but also on the ones you don't – stock selection is important.

The hopes that we'll transition soon from government steroiding back to an economy running on its own are overoptimistic; there is just too much stimulus in the economy for that to happen. The detox process from the massive consumption of steroids will not be a smooth and painless experience.

This transition will be slow and rocky, as today's stimulus wears off and we hit the wall in this economic marathon.

P.S. The four most dangerous words on Wall Street: "This time it's different." However, this time, this recession, is not the same, either; we are not suffering through your garden-variety corporate recession, it's a consumer one. Consumers, two-thirds of the economy and its past growth engine, are now the economy's weakest link: consumer debt-to-GDP is pushing 120%, double what it was in the 1980s. The financial system, though stabilizing, is hanging on the whims of one economic statistic: employment.

Over the last couple of weeks we have started seeing the first signs of a second (or third, I'm losing count) wave of layoffs. For instance, J&J, Electronic Arts, and Pfizer all announced they'll lay off a large percentage of their workforce. Higher unemployment will trigger larger loan defaults, and then we may even have another round of bank problems.



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