

Gary Shilling – Five Things that can Derail the Recovery

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Die-hard deflationists – those who foresee a continued bull market in bonds – are so few in number these days they could all share an elevator, according to Gary Shilling. One is Gluskin Sheff's David Rosenberg, whose views are considered [elsewhere](#) in this issue. But the loudest such voice belongs to Shilling himself, who has advocated for a long position in Treasury bonds continuously since 1980, a stance that has always proved prescient so far.

Shilling runs the New Jersey-based economic consulting firm the bears his name, A. Gary Shilling & Company, and he is the author of the recently-released book, *The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation*. He spoke last week in San Diego at the Strategic Investment Conference, sponsored by Altegris Investments and John Mauldin

Continued deleveraging was the overarching theme of Shilling's forecast, and I'll review why he believes that will keep inflation at bay.

Shilling's forecast came with five important caveats, and I'll also consider how those factors might upset the US recovery.

The age of deleveraging

The leveraging that took place in the US financial sector beginning in the 1970s and among consumers beginning in the 1980s ended with the financial crisis in 2008, Shilling said. But deleveraging since the crisis has so far been "minimal."

His long-term view is that it will still take "a number of years" to work off this leverage. This drawn out process may frustrate investors, but if this process were to accelerate the economy would fall into a depression that "would make the 1930s look mild by comparison," Shilling said.

Shilling called the current economic recovery "very slow" and said that US GDP is barely back to where it was 13 quarters ago, prior to the last recession.

That tepid growth came at the expense of trillion-dollar deficits, which Shilling expects to continue for many years to come, in the face of continuing unemployment. Historically, real GDP must grow at 3.3% annually to keep employment constant. Shilling, however, forecasted growth of only 2% in the near term, slightly better than the preliminary



announcement for the first quarter of this year but still not enough to keep unemployment from rising.

“No government, left, right or center, can stand for persistently rising unemployment,” Shilling said. “There's going to be immense pressure to do whatever it takes to create jobs. And that's why I think the deficit is going to remain high.”

Shilling said he does not advocate deficit spending, but he predicted that nothing substantial would happen to curtail it until at least 2013, after the next presidential election.

While deleveraging and deficits provide the backdrop, Shilling said the key to his forecast is the consumer savings rate, which declined from nearly 12% in the early 1980s to almost zero prior to the financial crisis. Today it is nearly 6%.

The drop in savings, he said, fueled growth in the US and most of the rest of the world; the global economy ultimately depended on spending by the US consumer.

But leverage caused spending to grow half a percent faster than after-tax income, and now that has reversed.

If the economy is going to show the kind of growth that the consensus expects – roughly 3% to 4% – he said it is “inescapable that the savings rate has got to stop going up, and it has got to start going down again.”

Indeed, Shilling said, there is nothing else in the economy that could generate the level of growth called for in consensus forecasts.

But it's unlikely that consumers will stop saving, Shilling said.

Historically, consumers maintained a debt-to-income ratio of 65%, but that grew to 131% prior to the crisis. It has since come down to 116%, but much of that decrease has come through foreclosures and write-offs of mortgage and credit card debt. Very little of it was actually debt repayment, Shilling said.

To believe in growth is to assume that consumers are willing to re-leverage themselves, which Shilling said will not happen.

“The savings rate is going to continue to rise and go back to double-digits,” he said.

Consumers have faced declines in their equity portfolios through two bear markets in the last decade and have lost substantial equity in their homes, he said, adding that 23% of mortgages are now underwater. A higher savings rate will compensate for losses in those sources of consumer wealth.



High unemployment will also push savings rates higher.

Shilling presented a persuasive case for deleveraging and deflation, but he still had to rebut the argument that quantitative easing and \$1.5 trillion in growth of the Fed's balance sheet will inevitably yield inflation.

Shilling's counterargument was that the "Fed does not print money." That's a statement to which many would take exception, since quantitative easing is nothing more than the electronic equivalent of running a printing press.

Shilling explained that the Fed does not print physical money through quantitative easing; rather, it creates money that, at least for now, exists as excess reserves on the banks' balance sheets, out of the course of general commerce.

With weak credit demand, the velocity of money shows no sign of increasing, and so the Fed's QE efforts "have had very little effect on the real economy," Shilling said.

Five factors that could derail the recovery

Shilling did not offer any scenario with upside beyond his forecast of slow growth, but he did identify five factors that could cause him to be wrong on the downside.

First was housing. Shilling was among those who correctly identified the housing bubble and predicted its collapse in 2006. Today, excess inventories – between 2.0 and 2.5 million houses – may lead to a further price decline of 20%, Shilling said, which is the decline necessary to bring housing back to its long-term trend. He cautioned that markets usually overshoot on the downside.

The oil market and the turmoil in the Middle East were Shilling's next concern. He said he wasn't sure how severe the problem might become, but he was adamant that high oil prices would not trigger inflation. "As long as you have high unemployment, there is virtually no risk that high oil prices would seep over into the wage structure," he said. "It isn't inflation; it's a tax – and it is a big tax on the consumer."

Japan was Shilling's third concern, and he called that country's economy a "slow motion train wreck." Japan faces a serious problem down the road financing its huge government debt, he said, which it has done so far largely by selling bonds to its citizens. That worked while Japan ran a trade surplus, but unfavorable demographics and a weak US consumer will eventually create a current account deficit, at which point the Japanese will have to borrow from foreign markets – at much higher interest rates than the 1.25% it pays now. That could lead to a "death spiral," he said, wherein additional debt would be necessary to fund interest payments.



Fourth on Shilling's list was the Eurozone debt crisis. Shilling said that he expects a restructuring to take place to resolve the problems facing Greece, Portugal, Ireland and perhaps Spain. A recession in Europe would follow, which would impair US exports. It will also create problems for the US banks, which collectively own 28% of the debt in the Eurozone.

A likely "hard landing" in China completed Shilling's list of concerns. China now faces 12% inflation, he said, which is very significant for the bulk of its population that earns modest incomes. Slowing down China's economy will be very difficult. Its central bank has already raised reserve requirements eight times since January of last year and raised interest rates four times over that period.

The Fed tried to engineer 12 "soft landings" for the US economy in the post-war period, and it succeeded only once, in the 1990s, Shilling said. It is unlikely the Chinese will be any more successful.

With a baseline forecast for slow growth and five downside scenarios that could potentially trigger a double-dip recession, Shilling expects interest rates to decline further. He said the 30-year Treasury bond will go to 3% from its current 4.4%, which translates to a 25% return. If you're brave enough to buy a zero-coupon bond, the return would be 40%.

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