The Jerome Levy Forecasting Center

Releveraging: Be Careful What You Wish For

August 2013

David A. Levy
Chairman

Recently, more investors have been talking about reflation and releveraging. Although the two terms are not the same, they are often used interchangeably, and both are tangled up with more bullish visions of where the economy might be headed. Many people are giving increasing credence to the possibility that by 2014 the U.S. expansion will become strong and slightly more inflationary as the world economy and commodity prices heat up along with it. Under this scenario, some believe private domestic credit in the United States would once again expand briskly, asset prices would rise, and the economy would get back to being its old self again, raising the specter of still more inflation and higher interest rates. This possibility seems to be motivating some investors to move out of bonds, move into corporate equities, nibble at real estate and other real assets, and rethink their options.

I am using the term "reflation" to mean what I think most investors mean when they use it: firing up the economy with fiscal and monetary policy to the point at which its performance returns to something more like the typical postwar experience. I say "I think" because people discussing reflation do not all agree on what they are talking about. Much of the thinking on the topic is extremely fuzzy and associative. Some define it as stimulating the economy through easy monetary policy, while other definitions include government spending in the list of policy tools. Still others state the goal to be reversing deflation, while others say it is boosting growth. Sometimes reflation means the easing of monetary and/or fiscal policy, and sometimes it means the resulting changes in the economy. The reflation discussion is all over the lot and, for the most part, poorly informed in two important regards.

First, it usually presupposes that the challenge is cyclical, one of simply getting the economy to grow fast again, with no awareness of the dominance of secular balance sheet problems. Even though many of the people anticipating reflation acknowledge such problems as heavy household debt and underwater homeowners as headwinds to economic expansion, they appear unaware that U.S. private balance sheets in the aggregate are still too big relative to income. Furthermore, almost no one understands that private balance sheets must expand if the economy is to generate any profits that do not come from government deficit spending.

Second, the reflation discussion assumes that if reflation succeeds, the economy will be out of the woods, with only normal cyclical risks to contend with. The truth is that sustained prosperity (with normal cyclical swings) will be achieved only after the contained depression has run its course.

By contrast, the *releveraging* discussion, which is considerably more sophisticated than the more amorphous reflation chatter, pays more attention to private balance sheets. The focus of the releveraging discussion is appropriately on private sector debt, the contraction of which is central to the macroeconomic events of the past five years, and to the potential for a sustained revival in debt growth. There is cautious but growing optimism that the U.S. economy is ready to releverage, that is, to enjoy briskly expanding debt, demand, production, and asset prices—perhaps finally getting back to the old normal.

Releveraging, however, is not so easy at this point in U.S. economic history. The long-term forces for balance sheet contraction persist. Although debt ratios have come down significantly in some parts of the economy—for example, for the largest corporations and for household's credit card debt—private debt levels in the aggregate remain extremely high relative to incomes (chart 1). The claim that low interest rates neutralize the high debt levels has some merit but ignores the vulnerability of any borrower with a high debt-to-income ratio to either inflation, which could raise nominal interest rates (not our immediate concern), or deflation, which shrinks income and raises real interest rates (a more serious threat in the years ahead).

Moreover, excesses on the asset side continue to discourage borrowing. The total value of assets owned by Americans is still

©2013 by the Jerome Levy Forecasting Center LLC

unusually high relative to the size of the economy, and, as we have explained previously, many allegedly low asset valuations (often judged using only a 25-year time frame) are actually high by broader historical standards. Overcapacity still outweighs areas of undercapacity in the business sector; for example, despite high rates of capacity utilization in mining (which includes oil and gas), overall industrial capacity utilization is exceptionally low for this far into an expansion.

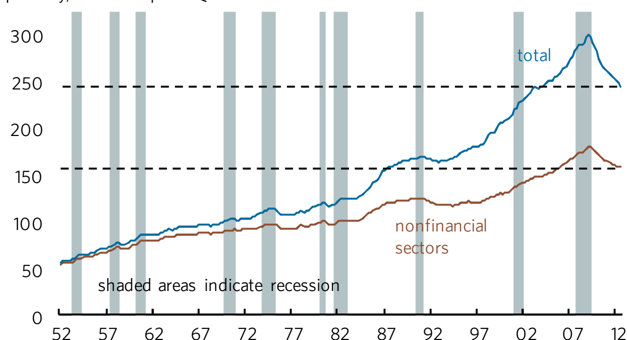
Secular balance sheet contraction does not mean that no type of debt can grow—obviously, several types have been expanding lately. Nor does secular debt contraction mean that total private debt can never rise at all; it may at times briefly increase fast enough to raise the business or household ratios of debt to income slightly. However, secular debt contraction does mean that the periods of debt expansion will tend to be weak, brief, and interspersed with declines, and that debt-to-income ratios will trend downward as the contained depression grinds on.

But is it *possible* to interrupt the contained depression and reestablish balance sheet expansion? Certainly. However, such an outcome would require a combination of easy credit, confidence in financial stability, an economy that has already been growing strongly, and expectations for continued rapid growth in order to encourage broad private credit growth. In our judgment these conditions would require an even more aggressively stimulative combination of fiscal and monetary policies than at present—and throw in an optimistic view of the global economy over the next few years.

Private Debt Ratios Remain High CHART 1

Private Sector Debt as % of GDP

quarterly, last data point Q3 2012



Why Present Policies and Circumstances Probably Will Not Lead to Releveraging

To understand the difficulties of establishing and sustaining releveraging under present conditions, it may be useful to examine four of the primary arguments for such releveraging from the Profits Perspective and in the context of the contained depression analysis.

1. "Policy is extremely stimulative and will remain that way."

Actually, fiscal policy is not easy in the context of private balance sheet retrenchment, and it is getting tighter. The federal deficit is large because private sector profit source weakness has caused it to swell to the point at which it supports the economy, but it is not inherently "easy." As for monetary policy, the Fed is still pushing on a string at the short end of the yield curve, and quantitative easing has not yet reached a magnitude or taken a form that would substantially affect nonfinancial private sector borrowing or spending. Moreover, the effect of QE on asset markets has been considerably less than many claim (see *The Exaggerated Importance of Quantitative Easing*, available on www.levyforecast.com).

2. "Businesses and households have deleveraged and are ready to releverage."

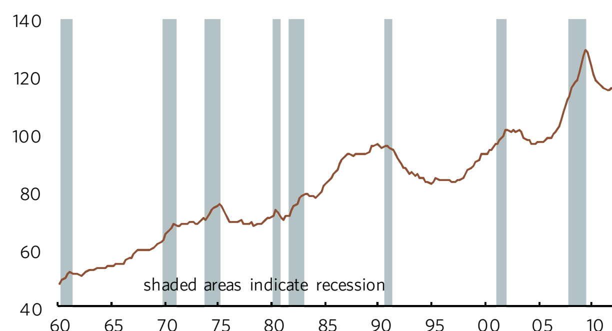
Although chart 1 shows overall debt ratios are still high, what about the facts that households' financial burdens are way down and that corporate balance sheets are lean? Isn't the private nonfinancial sector ready to borrow?

Despite the slimmed down balance sheets of large firms, nonfinancial business debt in the aggregate is still high relative to income (chart 2). We have previously written that while large corporations (which are most visible to the investment community) have lowered debt ratios somewhat and enjoyed even bigger declines in debt service costs in recent years, small and medium-sized publicly-traded corporations have had rising debt ratios. Moreover, the vast pool of privately held corporations and noncorporate firms do not appear likely to have reduced their own debt ratios—having had the least access to refinancing and having been hit disproportionately with sales losses. While the biggest firms have a huge influence in the business sector, and while they are in an excellent position to borrow if they want to, they have shown more interest in

Nonfinancial Business Debt CHART 2

Federal Reserve: Nonfinancial Business Debt as % of Gross Value Added

seasonally adjusted, last data point Q3 2012



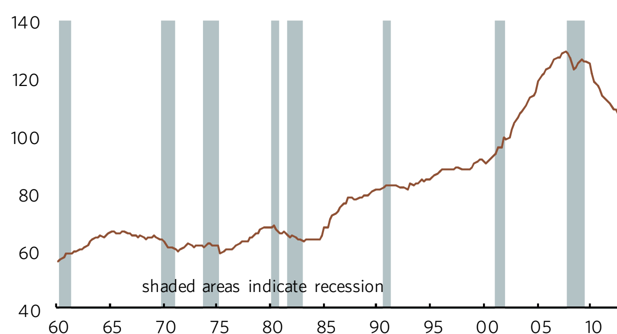
trimming overhead and making balance sheets leaner than in tapping their available credit. Even if big firms start borrowing more, the massive debt of other firms remains under pressure to shrink—whether through paydowns or, especially in economically stressful times, defaults.

The notion that households have deleveraged enough to start rapidly racking up debt is largely based on the financial obligations ratio, which we have explained is seriously skewed by shifting distributions of income and debt. Moreover, household debt remains unusually high relative to income (chart 3).

Household Debt CHART 3

Federal Reserve: Household Debt as % of Disposable Personal Income

seasonally adjusted, last data point Q3 2012



3. "With the fiscal cliff behind us and the housing market having bottomed, the economy is ready to take off."

The U.S. economy is not starting to take off, even though its uneven growth may at some point suggest a pickup as it has at various times over the past few years. There is a false notion that the resolution of key uncertainties has paved the way for stronger business expansion, but, in truth, the primary reasons why business investment has decelerated over the past year or so have been balance sheet excesses, the slow sales growth during the contained depression, and problems around the world. Overall, given the drag on fixed investment, the limits to any consumer credit cycle, and the impact of tightening fiscal policy, the economy is likely to continue growing slowly. Upside surprises for 2013 are possible, but we would worry more about downside surprises.

4. "Global conditions and economic policies will reinforce the U.S. expansion and raise its potential for releveraging."

The world economy is not improving enough to greatly enhance the U.S. prospects. Europe is not likely to improve and may worsen. China's acceleration depends on its new government's willingness to keep pumping out undisciplined credit at a breakneck pace in a game of chicken with increasingly unstable and pathological financial conditions. The world will do well to improve moderately in 2013 and could worsen.

Thus, the case for releveraging to gain traction any time soon has some problems. Moreover, there are aspects of a releveraging scenario that make it inclined to self-destruct even if it gets a start. One such aspect is the fact that an improving economy at a time of unusually large deficits will tend to encourage more spending cuts and tax increases, which would undermine profits and growth. A second is the tendency for the hotter economy to lead to fears of inflation and eventual Fed tightening and for these fears to manifest themselves in rising yields, which would undermine the housing recovery and provide a challenge for the stock market. A moderate inflationary scare could trigger a deflationary event.

Why a Sustained Releveraging Would Not Be Good

But let's toss away the obstacles and assume releveraging were to get underway. Assume deficits became as big and persistent as they would have to become and that the Fed's QE became as aggressive as necessary—whether that meant buying even more T-bonds, more MBS, corporate bonds, the Brooklyn Bridge, or Goldman Sachs. And assume that the world held together so that finally, with soaring profits, stronger growth, firmer pricing, rising asset prices, and cheap credit everywhere, the U.S. private sector began to borrow and invest again, turning those debt ratios back up. What would it mean? Surely, these events would be enjoyed in the form of rising wealth (at least on paper), higher employment, and rising incomes. But where would it lead?

Essentially, the economy would be heading back to where it was in 2007 with huge, unstable balance sheets. It would be like going back to the beginning of the contained depression and starting over, this time with much more federal debt at the beginning and a bulletless Fed. Moreover, in order to spark a few years of balance sheet expansion, the primary impetus would have to be financial speculation. With a huge volume of fixed capital depreciating, abundant excess capacity, and a need for business to see a sustained improvement in sales before anticipating greater capital needs, firms would spend judiciously on fixed capital for some time, and net business fixed investment would gain momentum relatively slowly. In short, the economy with still big balance sheets and still pricey assets could probably be induced to blow new bubbles before it would find sufficient motivation to finance booming investment in new capacity.

It is critically important to keep the depression contained, but in addition capitalism needs to clean up past excesses. That cleanup is not a pleasant process, and those who need to take losses will resist doing so until they are forced to acquiesce by market conditions or regulatory enforcement. Instead of what might have been merely a lost decade, Japan has suffered for 22 years largely because it delayed its cleanup in the 1990s. Europe has been too caught up in public debt problems and systemic stability issues to address cleaning up private sector finances much at all. The United States has started out better, but it has a great deal of cleaning up yet to do. It will take the strains of the contained depression and the more conservative attitudes it brings to expose and purge the rest of its balance sheet excesses.

The most likely and perhaps best course for the United States will be to continue to muddle through the contained depression, leaning on federal deficits and a secular improvement in international competitiveness while past balance sheet excesses are worked off and increasing financial conservatism pushes the process along. Ironically, too much prosperity could delay or even reverse the progress. An accelerating expansion that might look like the road to recovery would postpone America's return to sustainable prosperity and set up a new financial and economic disaster.

The reality is that there is only one major country in the world where the releveraging case really makes sense, and that is Japan, where balance sheets have already gone through a multi-decade period of retrenchment. The United States should not need 22 years of contained depression to reach its own revival, but it needs more than the five that have transpired so far.

macroeconomic insights for business and investment strategy

Improving risk management and providing a fuller understanding of economic trends with unique framework "The Profits Perspective"

Visit www.levyforecast.com

Contact Douglas Williams: DWilliams@levyforecast.com (914) 666-0641

© 2013 by The Jerome Levy Forecasting Center LLC. Based on an article in the February 2013 *Levy Forecast*. Redistribution of this publication in its existing form is permitted; reformatting or redistributing without attribution is prohibited.