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SPECIALREPORT

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The Saving Factor by Lance Roberts

Let me start out by saying up front that I am not a classically trained economist, I do not have a PhD in Economics from any Ivy League School nor do I spend my time delving in economic theorems. What I do have is about 30 years of experience in managing money, investing capital and building a variety of successful businesses in both good economic markets and bad ones. Therefore, while I may not have text book qualifications to do economic analysis what I do have the ability to do is research, analyze and apply real world experience and common sense to economics.

The problem with the mainstream economists today, especially our illustrious Federal Reserve Chairman, is that they honestly believe that economics is a science. It's not. Economics is an art – at best, just as investing money is. When working in a field that is truly scientific the results from any known action are always the same. For example – I know that if I combine two atoms of Hydrogen and one atom of Oxygen; I will get water. Not just the first time that I do it – but every single time. This is science.

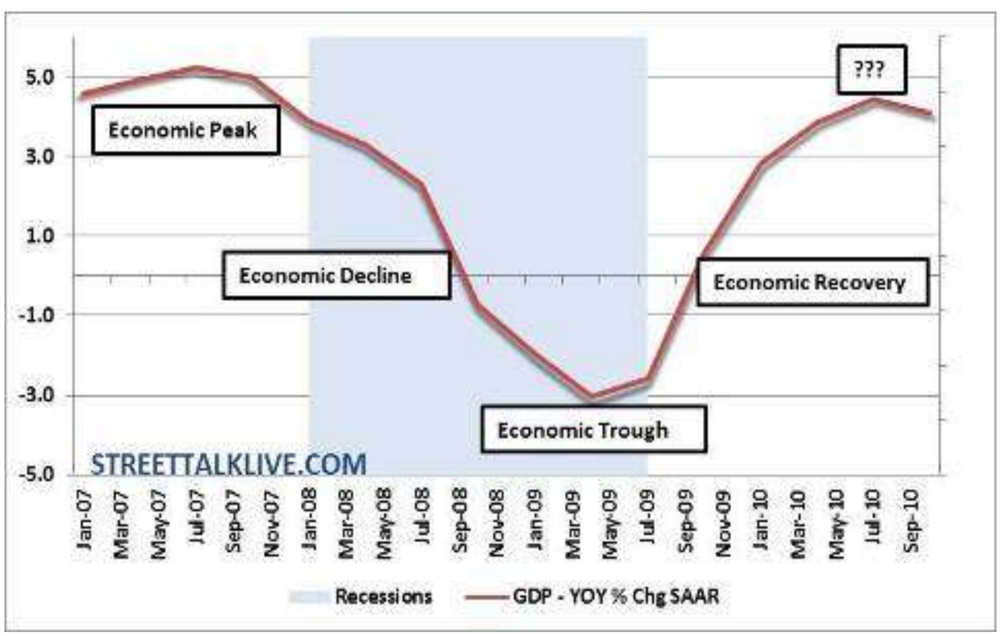
Economics and Investing is an art. I know that from 1900 to 1980 that every time the market traded at 23 times earnings that was the peak of the bull market and you should be out of stocks and into bonds. Therefore, if investing was a science, then the market should have never traded to 42 times earnings from 1980 to 2000. The analysis of getting out of stocks at 23 times earnings would have eventually been proven correct; however, unlike water, the application of the theory must be very fluid and dynamic taking into account the many variables that may skew the current actions away from the end conclusion. Economics is very much the same.

Like art, economics and investing, are more like the paint and canvas. I can paint the exact same picture a dozen times and no two paintings will be exactly the same…ever. So, when Ben and friends are trying to apply theories from the Great Depression and from Japan on our current economic depression – there must be realization that every landscape is different and the application of a theory in one environment will yield a totally different result in another.

This is why I want to spend a little time this week applying some common sense to our economic recovery because as an investor I do know that all investments are subject to the ebb and flow of the economic business cycle over time…it is just a matter of when – which is the "art" of investing successfully.

"Show Me The Recovery"

The chart to the right shows you the economic cycle that we have been in since January of 2007. This is a textbook economic recession showing the previous peak of the cycle, the decline, trough and recovery. Of course, the question we are all trying to answer as accurately as possible is whether we are at the peak, already of the economic cycle, is just a temporary slowdown before another economic advance or something else.



This is obviously a VERY important question to get right. However, let's take a look at a larger picture.

The next chart is the Year Over Year (YOY) percentage change in GDP since 1959. There are several important observations that we "common sense" economists *(that would be you and me)* should take away from this. The first is that we have been in a long term decline *(as noted by the red trend line)* in economic growth since we peaked in 1980. The second is that the recovery from the 2009 lows, while stellar, has only brought us back up to the long term downward trend line.

The question we need to try and answer is whether THIS economic recovery is going to a long term rise in economic growth as we saw from 1959-1980 or is this just a bounce on a continued decline in the long term growth rate in GDP.

Note: *In order for this newsletter to not become an entire book on economic common sense I will have to select just a few charts of the many that are available. So, yes, we can discuss the ramifications of data mining, research bias, etc., however, my goal here is to illustrate a point. I am* ***not trying*** *to sell you gold, guns or food so there is no bias intended* ***other than*** *to get you to "think" about what might happen to your money.*

Consumption Versus Savings

The current theory by "The Bernank" is that if the Fed supports asset prices (creates a rise in the stock market) that it will create consumer confidence and thereby encourage consumption. This has been the true purpose of Quantitative Easing as we discussed last week. It you didn't get a chance to read the article here is the link.

GDP is currently calculated as:

GDP = C + I + G + (X-M)

Where: C = Consumption
I = Investment
G = Government Spending
X = Exports
M = Imports

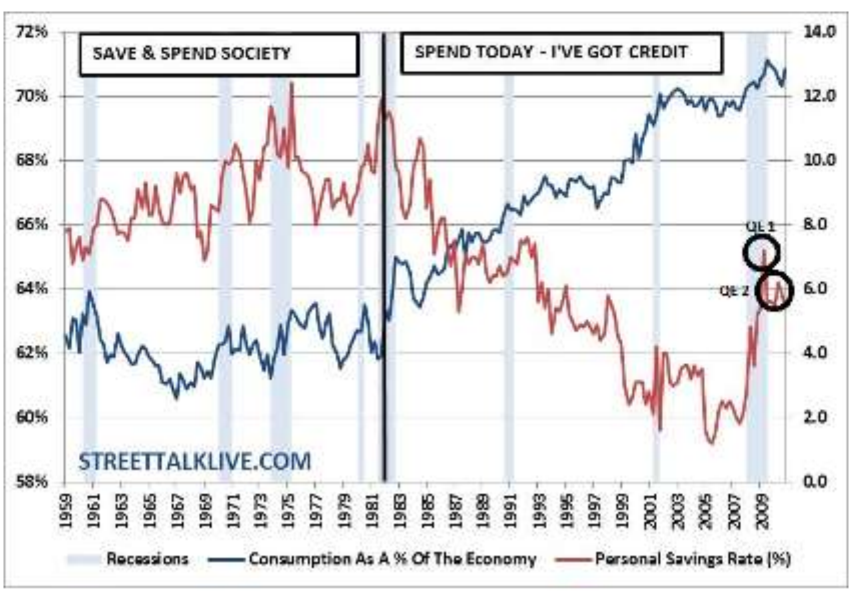
Let's take a look at the latest release of 4th Quarter 2010 GDP number.

"Downward revisions of **consumer spending (4.1% vs. 4.4% advance estimate)** [Consumption] and **state & local government outlays (-2.4% vs. -0.9% advance estimate)** [Government Spending] were the two major sources of revisions accounting for the reduction in the pace of growth of real GDP in the fourth quarter of 2010 to 2.8% from 3.2% in the advance estimate**. In addition, spending on equipment and software and residential investment expenditures were reported to have advanced at a slower clip in the fourth quarter.** [Investment]

Exports grew at a more rapid pace than previously thought, rising 9.6% versus 8.5% in the first estimate. **Imports** on the other hand fell 12.6%, less than previously thought." [Exports – Imports]

This is obviously very simplified analysis but you get the idea. "The Bernank" currently believes that by fostering asset growth it will have a spillover effect into the economy and get consumers' spending money. On the surface this theory seems credible as we do know that 70% of the economic growth comes from consumption expenditures. The consumption part of the economic equation, as shown in the simplified graphic to the right, is crucially important. Consumption leads off the entire cycle by inducing producers to produce more products to meet demand which requires more employees and materials, which creates more jobs and those jobs create more consumers.

We can also prove this assumption by just looking at the data. The following chart is of Personal Consumption Expenditures (PCE) as a percentage of the Gross Domestic Product. As you will see consumer spending has steadily made up a larger and larger part of Consumption part of the GDP Equation since 1982



The obvious question is what changed in 1982 that changed the way consumption played into the role of economic growth.

There is really no ONE singular event that occurred, however, whether it was a break in the back of inflation or interest rates, deregulation of utilities and airlines or the general change from a manufacturing society to a finance society – the attitude of the consumer shifted to a spend now, save later mentality.

As the mental shift occurred post 1981 the savings rate of Americans dropped marked from an average of 8-12% to ultimately close to 1%.

Not until the financial crisis did savings spike up back towards historical norms. That brief recovery into reality only lasted momentarily as it now looks like consumers are going back to their old habits – if not by choice then by necessity to make ends meet. Thanks primarily to Quantitative Easing.

Note: *The peaks in the savings rate in 2009 and 2010 coincides with the initiation of Quantitative Easing 1 and 2.*

There is one facet of this whole story that "The Bernank" is missing. While consumption is important to the overall economy – savings is even more important. There is one other formula that you need to know if order for our analysis to be complete;

S = I

Where: S = Savings
I = Investment

That little formula, as innocuous as it seems, actually has a fairly significant impact on the overall economic growth cycle. While the administration is focused on getting the consumer to spend to try and create an economic recovery maybe they should be focusing on savings. Let me show you what I mean.

The chart to the upper right is personal consumption as a percent of GDP versus the 10 year rolling change of GDP or growth in the economy. As you will notice as GDP on rolling basis grew as personal savings rate remained high and consumption as percent of the economy remained fairly stable around the 60-62% level of GDP.

Starting in 2000 the consumption blew through the 100% level of the debt to consumption ratio (second chart to right) as low interest rates and easy credit exploited the uneducated into living excessively beyond their means. When the reality came home to roost in 2008 it was only through increased government spending that the offset to the deleveraging of the common America.

So as we look forward and contemplate the possibilities for organic economic growth the reality of consumption and investment come directly into the cross hairs of the debate. We know households are far from having completed balance sheet deleveraging so necessary to ultimately set the stage for another credit cycle which defined the US economy since the early 1980's acceleration. However, what we now know is that it really isn't personal consumption that is the long term driver of economic growth – rather it is savings.

When households are maintaining a stable level of debt and have a high level of savings this fosters strong economic growth because there is cash and credit available for investment into building plants, manufacturing and creation of goods and services, as well as, consumption to create the virtuous cycle of economic growth.

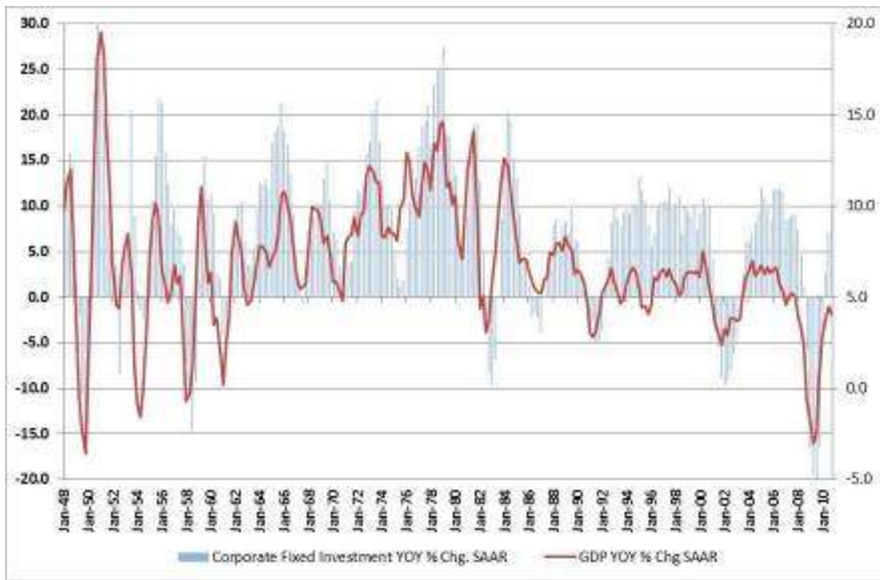
As stated in the wonderful economic theories and textbooks of life, in any economy it is **savings** that should equal investment in terms of balancing the books, so to speak. After tax disposable (spending on necessities inclusive of debt service) income can either be used for consumption or is saved, there are no other choices. Ultimately it is this pool of savings that becomes available for productive investment (whether borrowed for this purpose or invested as equity) in the macro sense for any economy.

I know – this fly's in the face of everything you have been taught and most mainstream economists will immediately dismiss it as drivel but the numbers, and common sense, really speak for themselves.

Fed Monetary Policy Is Failing

If everything we have said so far is correct then it is only a matter of time before the Fed and the current Administrations focused monetary and fiscal policies which exclusively on consumption will fail. If productive investment that is derived ultimately by increased savings that is the key to longer term sustainable economic health, and ultimately growth, then trying to push personal consumption to even higher levels by stripping savings will ultimately fail.

A key to this puzzle box that we are watching closely is corporate spending on productive plant and equipment. The Administration recently came out and provided a tax credit for capital expenditures to hopefully increase corporate consumption to help offset the lag in personal consumption. They also talked about a "shared responsibility" between eh government and business. The Fed realizes that their back is against the proverbial wall and they are hoping that by flooding the system with liquidity that the engine of economic growth will ultimately reassert itself.



Looking at the year over year change in, nominal US GDP (red line) compared to the year over year change in non-residential US fixed investment we can get a very broad proxy for productive investment/corporate capital spending.

These two data points are about as highly directionally correlated as they come. And what this clearly implies is that the longer term rhythm of the US economy is integrally tied to productive investment. **Not consumption, but productive investment.**

Trying to stimulate the economy through flooding the system with liquidity to encourage personal consumption is a process that will ultimately fail. By encouraging savings we can and completing the deleveraging cycle we can once again return to the cycle of productive investment which will create long term employment which will foster consumptive spending.

Conclusion

In the early 1980's we saw the peak in the US savings rate. This is also the same period where we began three decades of acceleration in US systemic leverage and a meaningful increase in consumption relative to GDP. That consumption was certainly financed with an ever accelerating amount of leverage, but also importantly it was also "financed" with a quarter century draw down in US savings.

Savings that otherwise would have become productive investment. Got it? Of course you do – it's common sense. From the late 1950's through to the early 1980's, the US savings rate reached ever higher highs, as exactly did the rolling ten year average of US GDP growth. But once the decline in the savings rate began, so did the decline in the longer term growth rate in US GDP. Want to fix the economy Ben? Encourage savings and debt reduction.

Lance Roberts – The "common sense" economist.

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