# Why we are Toast

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How US Consumers are Reacting to the Great Recession
Talk for the Chinese Bioscience Association

# Disclaimer

- Much of this talk involves my own interpretation and opinion—yours may differ.
- It should not be used as the basis of any business decision or personal investment.

# What Caused the Great Recession?

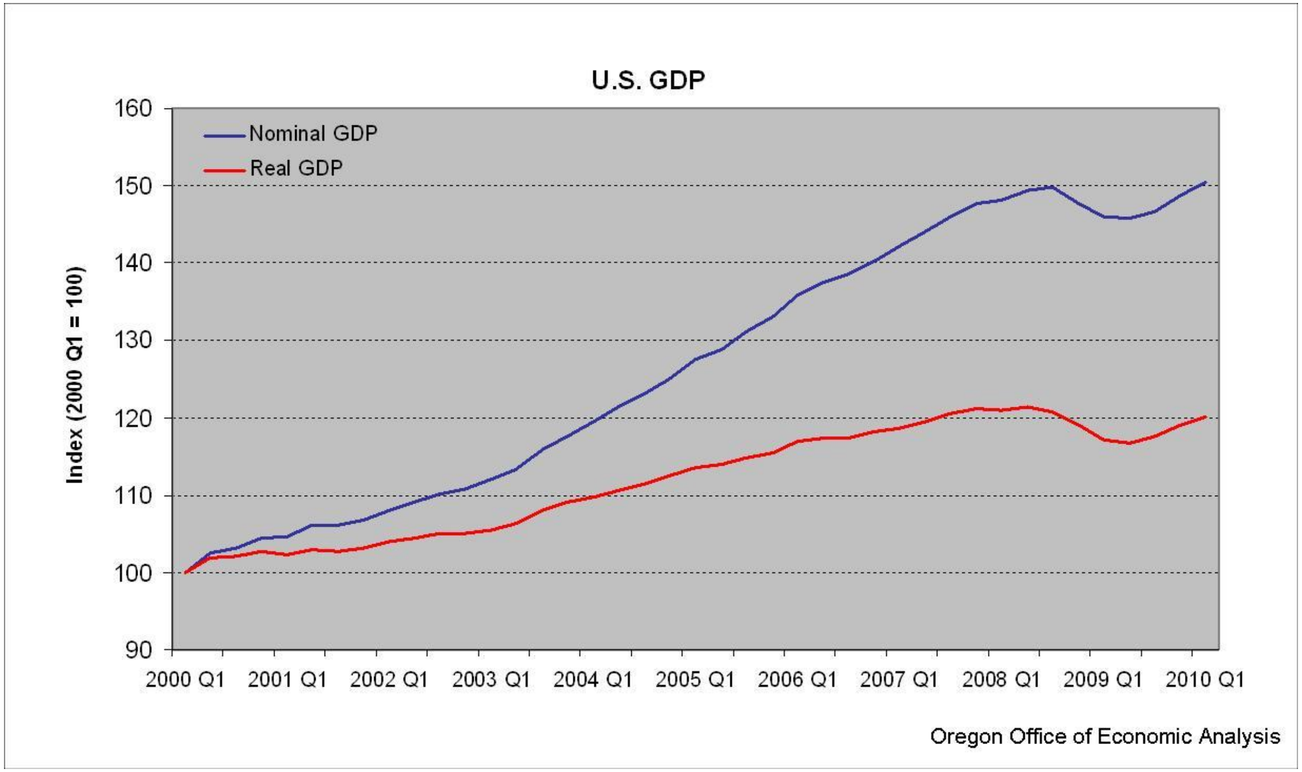
- Collapse of the US Housing Market
- In turn, due to interest rates that were too low, leading to a bubble in Asset Prices

# Part I: Reasons to be Optimistic

# US Economy is HUGE

- World economy is about $57 Trillion
- US GDP is $14.27  i.e. about 25 percent
  - We have just 5 percent of population
- US consumption (restaurants and retail) is about 70 percent of US GDP
- Therefore, US retail is .70 x 25 percent = 18 percent of World GDP.
  - ➔ Europe wants to criticize our deficits, but! 50 percent of all Porsches are sold in the US

# After a relatively small dip in GDP, we are back where we were in 2008



# The Recession has been Relatively Shallow

- A few quarters of contraction
- We’ve been back in growth for a few quarters
- Much of US business is just humming along
- It’s the “Patchwork Economy”—if you’re out of work, it isn’t much fun.
    - Otherwise, people are still out buying Lexus’s
- Corporate profits are fair and companies have a great deal of cash on hand

# Part II: Reasons to be Pessimistic

# 1. The Trade Deficit

- Exports: Right at $1 trillion a year
- Imports: Close to $1.5 trillion a year
- Imbalance had continued year after year
- Dollars flow out
- America “over-consumes”
- How this has not been self-limiting

# 2. Federal Budget is out of control

- Revenues: $1.914 trillion
- Expenditures: $3.615 trillion (2009 est.)
- More than $1 trillion a year overspending
- *Where is it going*?

1. *Unfunded wars  (where's the "sacrifice"?)*
2. *No-child & Rx drug benefit never funded*
3. *TARP and stimulus funds*

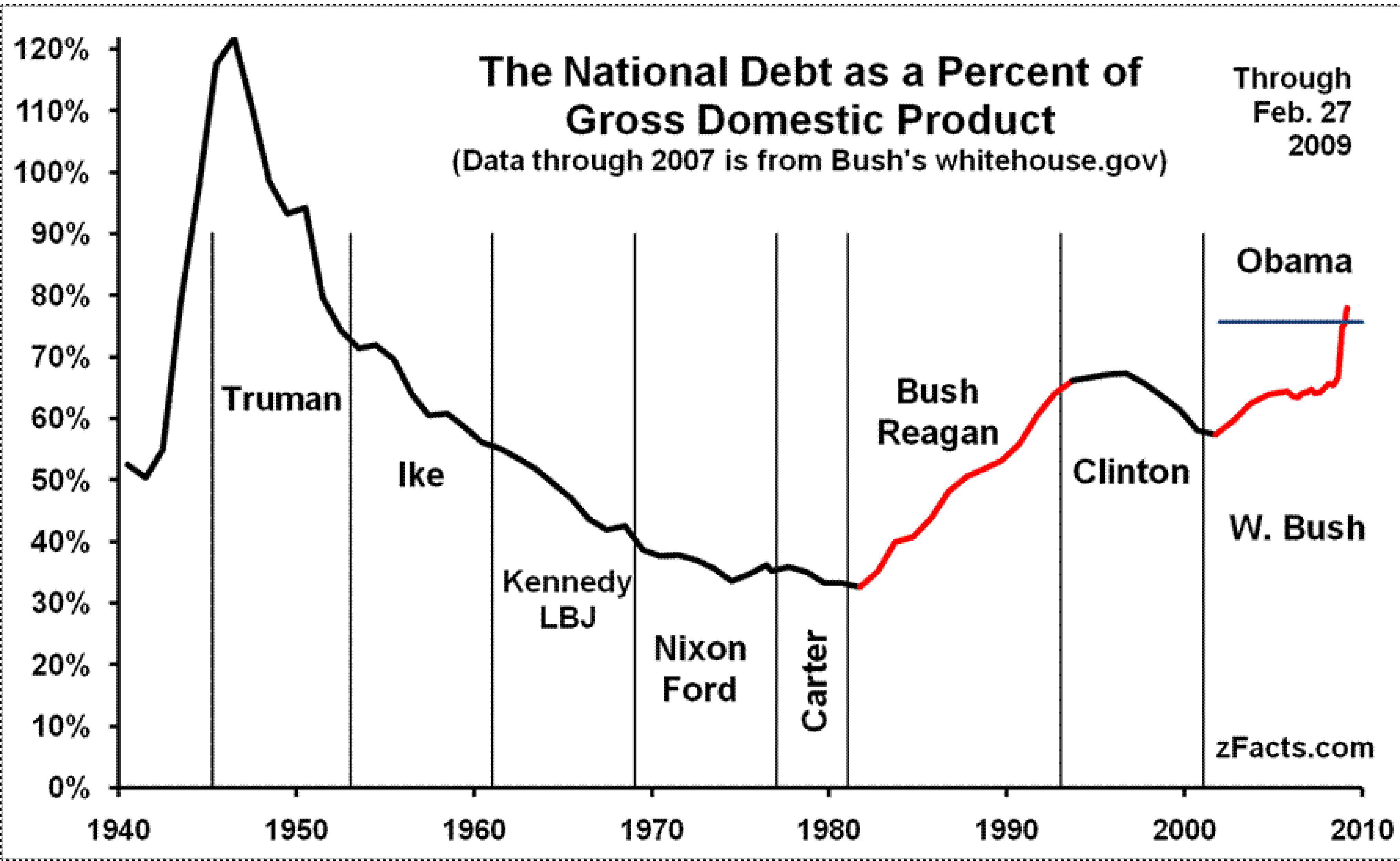
# It’s not so bad

1. We just owe the money to ourselves
   > Of $13 trillion, more than $3 trillion owed overseas and we’re increasing reliant on foreign investors (China has about $1 trillion in US bonds)
2. Our economy is so huge, it’s a small percentage of our GDP
3. Our economy will get back on track and we can afford to pay it off

# It’s not so bad

1. We just owe the money to ourselves
2. Our economy is so huge, it’s a small percentage of our GDP
   > Current Total owed is large by historic standards and leaping up dramatically (next slide)
3. Our economy will get back on track and we can afford to pay it off

# 2. The Federal Budget Deficits



# It’s not so bad

1. We just owe the money to ourselves
2. Our economy is so huge, it’s a small percentage of our GDP
3. Our economy will get back on track and we can afford to pay it off
   > To get back to historic ratios, we’d have to have the economy grow by about $2 – 2.5 trillion a year—that’s a 17 % growth rate (3 – 4 % is typical for the US in good years)

# What will happen as Federal Debt Rises?

Beyond 100 percent of GDP things get scary (*see Greece*)

1. Interest rates will rise
   > Corollary: Governments interest payments will rise, exacerbating the deficit problem
2. Other countries may refuse to continue to buy our debt
   > Estimates are that could add 2% to borrowing costs

# 3. We have spent the Social Security Trust Fund

- Of the $13 trillion in National Debt, we owe $2.5 trillion to ourselves in the Social Security Trust Fund
- That money start to be repaid (est 2015, some projections are <u>now</u> because people are unemployed
- Where has the money gone?
    - Spent on last years programs = “consumption, ” gone

# 4. The Housing "Bust" hasn't been fixed

- 100,000s of homes go into foreclosure each month
- Estimated 25 percent of all homes are "under water" (owe more than the home is worth)
- In some CA counties, 50 percent of all sales recorded this year are foreclosures
- We are about 1/3 through working through the homes that have to be foreclosed
    - It'll likely take 3 more years to clear, before home prices return to normal
    - Foreclosures and short sales depress prices and affect everyone else

# Why it will be very difficult to resolve the housing crisis

1. The foreclosure process is inefficient
   a. Many of the sketchy “originators” no longer exist
   b. The loans were sold and re-sold many times—often without the underlying paperwork
   c. The process of securitization slices and dices the loans so many times, it’s unclear who the real Mortgage Holder is (Wells Fargo & Bank of American are just servicing the loans
   d. The MERS has no legal foundation—judges are asking for the signed documents

# Why it will be very difficult to resolve the housing crisis

4. What are the options?
    i. Short sale: Bond holder takes a loss. The bondholder is your grandma (or CalPERS); very hard to find the owners
    ii. "Re-statement": Lower interest rate agreed with the mortgage holder—who owns this Mortgage
    iii. Reduce loans in bankruptcy, keep people in their houses ("the "haircut"): Fundamental violation of contract law; enriches those who borrowed foolishly
    iv. Have the government own the house, pay off the bond-holders and rent-back to the current homeowner: Massive government ownership of housing—not enough RE management; now-renters wouldn't keep up the property
    v. Re-fi everyone at 4.375 percent. This is the current government plan: It's even-handed (prudent borrowers can take advantage); people will be reluctant to move; doesn't help the 100,000s of sub-prime loans made to people who still can't afford

# What Policy Choices Does the Government Have?

# Scenarios: What may happen

- Note, this is not a difference over 2 percent or 3 percent growth—this is a dice-roll on alternate realities

# Scenarios: What may happen

A. We stumble along and return to our usual 3 percent growth, muddle through this and go back to business as usual
B. We stimulate a second time and return to robust growth
C. We become Japan—the “Long Flat Red”

# What's wrong with each of these

A. We stumble along and return to our usual 3 percent growth, muddle through this and go back to business as usual
> We can't grow fast enough, problems are too big

B. We stimulate a second time and return to robust growth
> One shot won't cover-up the structural problems of too high promises, not enough taxes

C. We become Japan—the "Long Flat Red"
> Big danger of this—20 years of 1 percent growth rate, National Debt 192 percent of GDP; bridges to nowhere; intransigent incumbent politicians funded by the construction industry

# What could we do?

How to come back from the brink

# What to do?
# 1. Get the Economy Right-sized

- Understand that the “pseudo-GDP” of the bubble years was fluff and stop trying to stimulate to get back to where we weren’t
  - People were using their houses as ATMs—that inflated house value wasn’t real wealth, it was funny-money
- Repeated stimulus spending will just make us into Japan: 20 years of no GDP growth and national debt = 2x GDP

# Right-sizing the Economy

# 2. Get the Federal Budget Under Control

- “We can’t have Scandinavian levels of benefits with Mississippi levels of taxation*”
- “Just say no” (we can’t afford it)
  IMO: Federal government can’t afford to spend <u>anything</u> on education, housing.

* *Regret, I can’t find the source for this quote that has been used in CA politics and in UK*

# 3. Increase Domestic Savings Rate

- In good years, it’s been 7 – 8 percent
- During the bubble, it actually went negative and has essentially been -0- for the last 10 years
- Therefore—policies that reward people who save for their future

# 4. Reward Companies that Boost Exports


- If it’s good for Boeing, it’s good for America

# 5. Stop over-consuming foreign goods

- Easiest way to do this: Weak dollar
- Get a handle on energy use
  (now 4 decades of lost opportunity since the "oil shocks")

# 6. Reform entitlements

- 22 percent of healthcare costs/year are for the last year of life
(est. 40 percent of Medicare expenditures)
    - In the Netherlands, it's just 10 percent
- Extend "working life" beyond age 66
[1 month a year for people > 10 years from retirement would do it]
- Get rid of the income related variable payout on Social Security (a fixed moderate benefit for all)

# What we are likely to see

Politicians will take the easy way out and will fail to right-size the economy and government budgets

# If we don’t take our medicine, here’s what will happen . . .

1. Failure to control government budgets
2. Much higher rates of taxation for generations
3. Sustained long-run weakening of the dollar
   a. Wheedles out of our long-term debt to other countries
   b. Imposes a hidden tax on imports
   c. Makes our exports attractive

Continues

4. Moderately high inflation for a very long period of time
    a. Would raise stock market nominal prices, helps re-fund retirement accounts
    b. Stealth-reduces real value of wages of government employees
    c. Reflate asset values, cure the housing crisis (no more underwater houses)