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INTERVIEW

Forecast: A Long, Cold Winter

Stephanie Pomboy, Founder and President, MacroMavens

By LAWRENCE C. STRAUSS

AN INTERVIEW WITH STEPHANIE POMBOY: It will take consumers at least five years -- and probably more -- to recover from this crisis.

"LIKE THE BUBBLE IN FINANCIAL ASSETS, THE NEW REAL-ESTATE bubble has its own distinctly disturbing characteristics," Stephanie Pomboy wrote in an April 2002 note titled "The Great Bubble Transfer." The founder and president of MacroMavens was on to something, even if she was early, and she worried about the big buildup of consumer debt fueled by rising home prices. Pomboy, whose Manhattan firm analyzes macroeconomic themes and their investment implications, remains bearish, convinced that a long period of paltry U.S. economic growth is in store -- akin to what happened in Japan in the 1990s. For more of her views and forecasts, read on.



Brad Trent for Barron's

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Barron's: *How bad has the macro economy gotten?*

Pomboy: It is certainly the toughest one any of us has lived through. My fear is that it's actually just in the early stages and that it is going to get substantially worse on the economic side, although all the government measures that have taken place so far might help to insulate some of the damage on the financial side.

What about the short-term outlook?

Having been bearish, for me the real challenge is to identify the turn. One thing at work right now is what I call the cattle prod -- essentially the Fed poking people to take risk. They are taxing cash by having negative real returns on cash. At the same time, yields on investment-grade and junk bonds are incredibly alluring. You can pick up 15 percentage points over cash buying junk bonds. Or you can pick up 8.5 percentage points on investment-grade paper. At some point, the cattle prod will get people moving, as it did in March of '03 when the market turned.

What else do you see happening in the near term?

With the government guaranteeing all manner of private-credit claims, many investors may decide to get long "socialism," for lack of a better term. Or, as some euphemistically put it, this is partnering with the government. So in the short run, we could see a rally in risky assets and a selloff in Treasuries. But the economic deleveraging has barely begun, and that's my longer-term thesis. It all revolves around the idea that U.S. consumers are actually going to do the unthinkable -- they are going to save -- and that we will be more like Japan than anyone believes is possible.

Hence, consumption declines.

Right. Wages have been silently crowded out by benefits as a share of total compensation, as companies look to offset rising health-care costs. The result is that the share of income that consumers can actually spend is at its lowest in the post-war period. It had not been a problem, because consumers would just borrow to fill that gap. But now, they don't have appreciating assets against which to borrow. So while we could get a rally in risk assets -- including high-yield debt -- it's likely to be a short-term rally within a context of a secular bear market.

Any other important longer-term trends you expect?

We are going to see a secular rotation from paper assets to hard assets like gold. The whole global competitive currency devaluation, including that of the dollar, plays right into that.

Do you see any asset classes besides junk bonds benefiting from a short-term rally?

There is a chance that equities participate in that rally as well, although I think investment-grade corporate credits look much more attractive than stocks. But when you think about pension funds that are trying to make 8% annual returns, they are not doing it by getting 1% on two-year Treasury notes. They can't use the secret sauce of leverage anymore.

If I was going to hold my nose and buy anything, I probably would buy higher-quality corporate credits. If you want to get long socialism, one of the next segments of the market that will be given a guarantee will be municipal bonds. That's because state and local governments are a huge share of total [gross domestic product] and employment, and we can't afford to have them down for the count.

One thing that caught our eye in one of your recent notes was the steep decline of Treasury-buying by foreigners. What are the ramifications of that?

We are acting as though there are no consequences to basically running the money off the printing press and handing it to the Federal government to backstop financial markets or bail out homeowners or what not. There is no consequence to doing this, unless or until the rest of the world says to us, 'We don't like this game' and 'We don't want to have all the dollar claims we are holding debased by [Fed Chairman Ben

Bernanke] running his printing press.'

So if foreign investors stop buying Treasuries, or even significantly pare their buying, that means higher rates in the U.S.

That's correct. But then [Bernanke] will start buying Treasuries to arrest the rise in interest rates. I've always had a very simplistic view about this: Either we are going to pay for our policy sins via higher interest rates or a weaker dollar. And for an economy that is as levered as the one in the U.S. is, the former choice is not an option. We can't pay through higher interest rates; we barely got to 4.5%, 5% before the whole subprime crisis erupted. So a weaker dollar is the natural valve. But right now, we are enjoying some real competition in the ugly contest from the currencies of the European Union and the United Kingdom, and that will probably persist for a while because they are in pretty bad shape, and they are a little bit behind the curve relative to us.

Could you elaborate on that choice between higher rates or a weaker dollar?

If we rely on foreign creditors to lend us the money to sustain our lifestyles -- and that's what we do -- we need to compensate them for that risk of lending to us. As the economy weakens and our credit quality should theoretically be deteriorating, the only way we can really attract that same capital is by offering a higher interest rate or making our assets cheaper to them, in this case by having our currency be weaker.

How would you assess the job Fed Chairman Bernanke and Treasury Secretary Henry Paulson have done in responding to the financial crisis?

My preferred solution would have been to do nothing. I think it's the meddling of policy makers that got us into this situation in the first place, along with the asymmetric practice of capitalism where, as long as everyone is succeeding, it is wonderful thing -- but the moment someone fails, we need to revert to socialism. That is really how we got to this place. And [former Federal Reserve Chairman Alan] Greenspan's desire to constantly lubricate any pain by pumping money into the system really created this bubble. But since doing nothing was not a compelling option to [Bernanke and Paulson], I would have favored more aggressive action to arrest home-price deflation, which would have been tackling the disease. Instead, they've chosen to treat the symptoms. Having said all of that, Bernanke and Paulson are determined to mitigate the pain.

You were concerned about housing before it blew up. What worried you?

First, it was the incredible expansion in lending on housing. I was also focused on the share of household income that was actually spendable money, and it was puzzling how consumers could sustain consumption when their income certainly wasn't supportive of that. Clearly, the reliance on asset inflation as a substitute for income was a major source of concern for me.

It also shocked me that as a share of bank assets, exposure to real estate was at a record level. Almost 50% of total bank assets were either in first mortgages, mortgage-backed securities or investments in real estate, and that was unprecedented. And yet

there seemed to be this general idea that 'Oh, no, the banks had securitized and off-loaded all of their real-estate risk.' Clearly, as we have discovered, that was not the case at all. Yes, they securitized a lot of mortgages, but then they turned around and invested it in mortgage-backed securities. Ultimately, they ended up sitting on record exposure to one of the biggest bubbles in our lifetime.

What kind of economic conditions do you see going forward?

I expect that we'll just have a prolonged period of subpar growth. I don't think it will be exactly like Japan, but it will be Japanese. Clearly, we have been far more aggressive in the U.S., in terms of policy actions. But what will happen here is that credit is no longer the answer, because households decide they don't want to borrow. As a result, the government will really become more important as spender of last resort.

What domestic GDP growth will we get?

In terms of nominal GDP, I see it being around 1% for a long time, five years for sure. One thing to consider is that after the dot-com bubble burst, it took the corporate sector five years to get back to the 2000 peak for capital expenditures, and employment never got back to that level. And the tech bubble was nothing as a share of total assets compared to housing on household balance sheets. This is so much larger. If it took the corporate sector five years to recover from the bursting of the dot-com bubble, to suggest that it would take five years for consumers to recover from this seems like a very conservative call.

What about unemployment?

Having the standard unemployment rate at 10% is definitely a possibility, though it does depend on what is done in terms of the state and local governments, which are 13% of total employment. But they have been the only area that is growing right now in terms of employment.

Where do you see rates going?

I have been bullish on Treasuries, and I did feel silly sticking with that view, because I'm really squeezing the last couple of basis points out of a multi-decade bull market. Having said that, looking back at the charts of JGBs [Japanese government bonds] in 1989, I am certain no one back then thought JGBs would ever yield under 1%. And here in 2008, even in the dark recesses of my bear cave with all the other growling bears in there, nobody believes that could happen here. There's this sense about how horrible it is that Treasuries have been able to get to these low yields, and I totally agree.

We are really abusing the privilege of dollar hegemony by printing all this money. But if I'm right and the whole economic deleveraging is still to come, you might get a selloff in Treasuries on this short-term rally in riskier assets. Then, the next thing you know, people will say, "Oh, wait. Consumers aren't coming back to the trough, this is a problem," and the market will sell off further. So on balance, I wouldn't short Treasuries.

Where do you see opportunities?

In terms of absolute returns, it is going to be very hard to come up with really compelling ideas. I like hard assets in this environment, gold in particular, where basically the major currencies are all being debased. I also think emerging markets, on a relative basis, are going to do much better than developed markets are.

We are all hanging on the edge of our seats to find out if China can pull off keeping its economy going while the rest of the world goes down the tubes. This shock-and-awe stimulus that China is applying to its own economy certainly speaks to its urgent motivation to ensure that its GDP growth stays at 10%-plus. So with the arsenal of foreign reserves they can continue to tap to support growth, I would be looking at going long equities in emerging Asian countries, including China, as well as commodities, which move hand-in-hand with emerging markets.

Why would China want to lighten its holdings of Treasuries?

It just seems to be a no-brainer that you would rather support local consumption than buy U.S. Treasuries. The interesting thing is that, contrary to most people's impressions, foreign holdings of Treasuries are really short term. Fifty percent of foreign Treasury holdings have a maturity of three years or less, so foreign holders are constantly facing the decision of what to do with rolling over that paper. It can change very quickly.

What keeps you up at night?

I do worry about preservation of capital from the standpoint of how many more unconventional policy actions we are going to have. If I'm correct about the economic deleveraging still ahead and that it will continue for many years, that's a legitimate concern.

That's why I'm long gold. I view it as the best way to protect my capital. The other worry is unemployment and this vicious circle where as consumers spend less, companies make less money, and they cut back workers.

The unemployment rate continues to rise. It is very hard to figure out how you break out of that.

Thanks, Stephanie.
