

## Comstock Partners, Inc.

### Deleveraging the U.S. Economy

We are in the process of deleveraging the most leveraged economy in history. Many investors look at this deleveraging as a positive for the United States. We, on the other hand, look at this deleveraging as a major negative that will weigh on the economy for years to come and we could wind up with a lost couple of decades just as Japan experienced over the past 20 years. It is true that Japan didn't act as quickly as we did but our debt ratio presently is much worse than Japan's debt ratios throughout their deleveraging process.

Presently, the stock market is exploding to the upside, which you could say argues against the case we are attempting to make in this special report. However, if you step back and look at the larger picture, you can see that the stock market is still down over 35% from the highs reached in 2007 and also down over 33% from the highs reached in early 2000. In fact, the market now is acting in the same manner as it did in early 2000 at the peak of the dot com bubble and again in 2006 & 2007 at the combined housing and stock market bubble.

This seems to us to be a "mini bubble" of stocks reacting to an abundance of "money printing" by governments all over the world since stocks are rising worldwide. Of course, if the U.S. doesn't recover there will be no worldwide recovery since the rest of the world is still dependent upon the U.S. consumers' appetite for their goods and services (despite the so called growth of domestic consumption in China and India). We, however, don't believe that the U.S. massive stimulus programs and money printing can solve a problem of excess debt generation that resulted from greed and living way beyond our means. If this were the answer Argentina would be one of the most prosperous countries in the world. This excess debt actually resulted from the same money printing and easy money that we are now using to alleviate the pain.

Most investors believe the bailouts, stimulus plans, and quantitative easing will lead to inflation. In fact, almost all of the bearish prognosticators are negative because of the fear that interest rates will rise once the inflation starts to work its way into the economy. They point to the doubling of the monetary base which they believe will soon lead to rising prices as more dollars are created chasing the same amount of goods. We, on the other hand, are not as concerned about the doubling of the monetary base because we believe the excess money will need the money multiplier and increases in velocity in order to increase aggregate demand and eventually inflation. As long as velocity (turnover of money) is stagnant we expect the increases in the monetary base and all the quantitative easing will lead to a stagnant economy and deflation until the consumer goes into the same borrowing and spending patterns that was characteristic of the 1990s through 2007.

Remember, over the past decade (when we believe the secular bear market started) the total debt in the U.S. doubled from \$26 trillion in 2000 to just over \$52 trillion presently (peaking a few months ago at \$54 trillion). This consists of \$14 trillion of gross Federal, State and Local Government debt and \$38 trillion of private debt. We expect the private debt to continue declining in the future as the deleveraging of America unfolds, while the government debt will very likely explode to the upside as

the government tries to slow down the private deleveraging by helping out the entities and individuals in the most trouble with debt (such as over-extended homeowners).

We wrote a special report in January of this year titled "Substituting Debt for Savings and Productive Investment" in which we explained why the U.S. economy historically prospered because of hard working Americans saving a substantial amount of their income which was used for productive investment. Unfortunately, all of this changed over the past few decades and got worse over the past decade. In fact, we stated in the report that it took \$1.50 of debt to generate \$1 of GDP in the 1960s, \$1.70 to generate \$1 of GDP in the '70s, \$2.90 in the '80s, \$3.20 in the '90s, and an unbelievable **\$5.40 of debt to generate \$1 of GDP in the latest decade**. Over the past two decades, while most investors thought this trend could continue indefinitely, we have been warning them of the catastrophic problems associated with this ballooning debt.

The attached chart of total debt relative to GDP shows exactly how much debt grew in this country relative to GDP (it is now 375% of GDP). The total debt grew to over \$52 trillion relative to our current GDP of approximately \$14 trillion. This is worse than the debt to GDP relationship in the great depression (even when the GDP imploded) and greater than the debt to GDP that existed in Japan in 1989. Even if you took the debt to GDP when the U.S. entered the secular bear market in early 2000 and compared that to 1929 and Japan in late 1989, our debt to GDP still exceeded both (by a substantial margin relative to 1929). The approximate numbers at that time were about 275% in the U.S. in early 2000, 190% in 1929, and about 270% in Japan in 1989.

In fact, the similarities between Japan's deleveraging and the U.S. presently are eerie. Japan's total debt to GDP increased from 270% when their secular bear market started to just about 350% 7 years later (1998) before declining to 110% presently. The U.S. increased their total debt to GDP from 275% of GDP when our secular bear market started (in our opinion) to 375% presently (10 years later), and we suspect the total debt to decline similar to Japan's even though the Japanese government debt tripled during their deleveraging. The government debt relative to GDP was about 50% in both the U.S. and Japan when the secular bear market started. We also suspect that our government debt will grow substantially just like it did in Japan as the private debt collapses. Also, the Japanese stock market doubled during the three years preceding their secular bear market in 1987, 1988, and 1989 while the U.S. market also doubled during the three years preceding the beginning of our secular bear market in 1997, 1998, and 1999.

There also a few significant differences between the U.S. and Japan. The private debt in Japan was almost the reverse of the U.S. where most of our excess debt was in the household sector and most of the excess debt in Japan was in the corporate sector. The debt to GDP figures in Japan were not easy to come by from the typical sources until the mid 1990s and had to be estimated, but should be pretty close to the numbers used above. Our sources on the above Japanese debt figures came from Ned Davis Research and the Federal Reserve Bank of San Francisco. NDR's report, "Japan's Lost Decade-- Is the U.S. Next?" have great statistics and

information and the Fed's report "U.S. Household Deleveraging and Future Consumption Growth" is well worth reading.

The Fed study charted the peak of the debt related bubble of the stock and real estate assets in Japan in 1991 (1989 for stocks and 1991 for real estate) and overlaid it with the peak of U.S. debt associated with the same assets in 2008. They concluded that if we are able to liquidate our debt at the same rate as Japan we would have to increase our savings rate from the present 6% (artificially high due to the recent stimulus paid to households) today to around 10% in 2018. If U.S. households were to undertake a similar deleveraging, the collective debt-to-income ratio which peaked in 2008 at 133% (H/H debt vs. Disposable Personal Income) would need to drop to around 100% by 2018, returning to the level that prevailed in 2002.

If the savings rate in the U.S. were to rise to the 10% level by 2018 (following the Japanese experience), the SF Fed economists calculate that it would subtract  $\frac{3}{4}$  of 1% from annual consumption growth each year. We did a weekly comment about this very subject on June 25 of this year and came to a similar conclusion. In that same report we showed that from 1955 to 1985 that consumption accounted for around 62% of GDP. Because of the debt driven consumption over the past few years at the end of March 2009 consumption accounted for over 70% of GDP. If the percentage dropped to the normal low 60% area of GDP it would subtract about \$1 trillion off of consumption (or from \$10 trillion to \$9 trillion). We also showed in that same report that H/H debt averaged 55% of GDP over the past 55 years and was 64% as late as 1995. It has since soared to over 100% of GDP giving a big boost to spending that will be reversed as the deleveraging takes place over the next few years.

Other problems we have in the U.S. that will exacerbate the deleveraging are excess capacity, unemployment rates skyrocketing (putting a damper on wages), credit availability contracting, and dramatic declines in net worth. The attached chart of capacity utilization is self evident that excess capacity in the U.S. has just dropped to record lows with the manufacturing capacity dropping to under 65% and total capacity utilization is just a touch better at 68%. It is very hard to imagine corporations adding fixed investment at this time. With unemployment rates close to 10% and rising, it is unlikely that wages will grow anytime soon. The charts on credit availability and net worth reductions are self explanatory and will also put a damper on consumer spending rising anytime soon.

We expect that the U.S. deleveraging will follow along the path of Japan for years as real estate continues to decline and the deleveraging extracts a significant toll from any growth the economy might experience. We also expect that, just like Japan, the stock market will also be sluggish to down during the next few years as the most leveraged economy in history unwinds the debt.

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