The Economy
Emerging from Policy Purgatory

By Michael Jones, CFA®

Policy decisions—or indecisions—of governments and central bankers around the world have driven financial markets for much of the past four years. Uncertainty over the outcome of these policy choices has kept markets edgy and volatile compared to historical norms, a condition we have described as “policy purgatory.”

We believe that policy purgatory with respect to monetary policy ended during 2012, as the central banks of the United States, Europe, and recently Japan committed to potentially unlimited monetary accommodation.

While monetary policy has emerged from purgatory, fiscal and economic reform policy in the United States, Europe, and China has not. We believe that intensifying political and market pressures will force a resolution to outstanding issues over the next several months, allowing financial markets to emerge from the shadows of policy purgatory.

If fiscal policies and economic reforms implemented in 2013 are as consistently favorable for financial markets as the monetary policies of 2012, then economic growth could accelerate with equity markets posting another year of 10-percent to 15-percent returns. However, we do not expect many politicians to implement appropriate long-term solutions. Instead, once again, most are likely to cobble together a series of short-term policies that defer many of the difficult decisions and needed reforms. In this “muddle through” scenario, we believe that global equity markets still could rally as much as 10 percent thanks to both the extraordinary monetary stimulus started in 2012 and relief that a worse outcome was avoided.

We must acknowledge the risk, although unlikely in our view, that politicians from Washington to Brussels to Beijing all will fail to reach even short-term solutions. The dire consequences of such a failure are the primary reason why we believe that politicians will continue to forge compromises at the last minute. However, the emotional nature of the issues makes an irrational stalemate a possibility. In this scenario aggressive monetary policy only softens the impact of failed political processes, the global economy likely lapses into recession, and equity markets give back most of their 2012 and early 2013 advance.

Central Banks Are “All In”

In 2012 the world’s central bankers resolved some of the uncertainty over economic policy with definitive monetary policy guidance, guidance that we believe is extremely favorable for financial markets. The U.S. Federal Reserve is purchasing $85 billion of government securities every month (both Treasuries and mortgage-backed securities) until unemployment drops to 6.5 percent. The European Central Bank (ECB) has pledged unlimited support for Italian and Spanish bond markets, provided they submit to budgetary and policy oversight from the rest of the euro bloc. Thus, after three years of market uncertainty, the ECB has assured a sufficient backstop for the funding needs of these highly indebted economies. Even the Bank of Japan, after 20 years of ineffective policies, has committed to aggressive asset purchases (QE) until Japanese inflation rises above 2 percent.

These extraordinary open-ended policy commitments, combined with aggressive interest rate cuts in most emerging markets (see figure 1), suggest

![Figure 1: Emerging Market Central Bankers Are Once Again Lowering Interest Rates](image-url)
that for the first time since 2009, almost every central bank in the world is “all in” with their most powerful monetary tools. This coordinated monetary easing is a powerful tailwind for equity markets across the globe.

The United States: Higher Taxes Offset By Improving Housing

Since the onset of the financial crisis in 2008, the United States has pursued the most consistently aggressive policies among the world’s economies to help support economic growth. Unlike most central banks, the Federal Reserve never retreated from its zero interest rate policy, periodically enhanced this stimulus with asset purchases (QE), and now has committed to aggressive QE every month for the foreseeable future. Similarly, the United States has attempted to stimulate its economy with various spending and tax-reduction programs, prompting unprecedented peacetime deficits in each of the past four years. Unlike the austerity programs in Europe, the U.S. government made no effort to rein in its rapid accumulation of debt during 2009–2012.

Our baseline scenario for 2013 assumes that the combination of tax increases and spending cuts known as the fiscal cliff will be partially avoided, but that no grand compromise is reached for long-term deficit reduction. We think any resolution to the fiscal cliff negotiations will require the United States to take its first steps away from aggressive fiscal stimulus in 2013 through a combination of tax increases (especially Social Security taxes) and sequestration spending cuts. We expect these changes in fiscal policy to put the overall budget deficit on a significant downward trajectory and subtract approximately one percent of nominal GDP.

Housing starts are climbing rapidly, and, after four years of subtracting from gross domestic product (GDP), housing is poised to add a small amount of growth in 2013 (see figure 2). The Congressional Budget Office (CBO) estimates that the U.S. economy requires approximately 1.5 million new homes per year to accommodate new household formation and replace worn-out housing stock. We believe that housing starts could increase back to the 1.5-million unit level, ending a four-year period of depressed activity that worked through the overbuilding of the 2000s. Such acceleration in home construction could add between 0.5 percent and 1.0 percent to the overall economy.

In addition, home prices are a primary driver of consumer confidence (see figure 3). If home prices stay on their current trend, the direct contributions of housing to the overall economy could be equalled by the impact of improved home prices on the much-larger consumer spending component of the economy. Thus, despite the higher taxes and lower expenditures likely to result from the current political stalemate, our baseline forecast is for a continuation of slow but steady 1.5-percent to 2.0-percent economic growth. On the bright side, although the United States is likely to continue experiencing painfully slow growth, the drivers of economic growth are shifting from an unhealthy dependence on government deficit spending to increasing reliance on the private sector.

Grand Compromise: A Long-Shot Upside Scenario

Accelerating from new normal growth rates (1 percent to 2 percent) will require politicians to move beyond the short-term fiscal cliff negotiations and actually enact a plan to control the U.S. government’s growing debt obligations. Philosophical disagreements about the best way to rein in unsustainable government deficits lower the odds of a grand compromise, but President Barack Obama may surprise investors by actively pursuing such an agreement in 2013. Like all second-term presidents, President Obama increasingly will be concerned about his long-term legacy. History will not be kind if President Obama bequeaths the current fiscal chaos to his successor.
Business leaders and consumers know that controlling our long-term debt problems likely will require either major reforms to entitlement programs (especially Social Security and Medicare) or tax increases and spending cuts well beyond the levels incorporated in the fiscal cliff compromise and budget sequestration. Although these changes in fiscal policy will subtract from economic growth, most of them would not take effect for many years. By contrast, certainty for tax and spending policies (i.e., knowing whose taxes go up and whose spending is cut) could unleash some of the cash companies are holding due to uncertainty. Thus we believe that a knowing whose taxes go up and whose spending is cut) could unleash some of the cash companies are holding due to uncertainty. Thus we believe that a compromise and budget sequestration. Consequently, labor costs in Greece, Italy, Spain, etc. are much less competitive than in Germany, and few businesses see these economies as attractive locations for new facilities. For example, Airbus depends on support from the French government, yet it will locate its new production facility in Alabama.

Although labor costs are peripheral Europe’s primary problem, European policymakers have spent most of their time and political capital since the onset of their debt crises on forcing bailout recipients to meet stringent budget deficit targets. Since political realities assure that deficit reduction packages rely predominately on tax increases, these austerity requirements have helped drive these economies into deep recessions/depressions (similar to the large U.S. tax increases in 1930 and 1931).

For the euro to survive over the long run, Italian and Spanish labor costs must fall into alignment with those of Germany, in our view. Market hopes for such a policy transition were heightened when the president of the International Monetary Fund (IMF), a main proponent of austerity, contended in a CNBC interview that “austerity on top of austerity doesn’t work” and that the IMF should focus on requiring reforms in labor laws and tax policies in the future. Unlike mandated tax hikes and spending cuts, requiring badly needed economic reforms could stimulate rather than impede economic growth in European economies.

**Europe: Will It Finally Abandon “Hoovernomics”**?

One by one, European policymakers have abandoned tight monetary and fiscal policies as a prescription for their debt crises. We have described the European strategies as “Hoovernomics” due to their similarity with those implemented by the Hoover administration in the early years of the Great Depression. The ECB’s long-term refinancing operations (LTRO) program and interest-rate reductions have reversed the restrictive monetary policies of 2010 and 2011. The ECB has further agreed to provide unlimited financial support to Spain and Italy if they agree to policy oversight by the rest of Europe. The conditions of this policy oversight provide an opportunity for Europe to abandon the last elements of Hoovernomics.

Peripheral Europe’s debt problems are a symptom of the real problem: uncompetitive labor costs. For much of the post-World War II era, these countries have embraced labor and regulatory policies that elevated labor costs relative to less-restrictive economies such as Germany. Until the advent of the euro, peripheral Europe tended to compensate for higher labor costs by periodically devaluing their currencies, essentially cutting worker pay through a cheaper currency and lower standard of living.

By entering a currency union, these countries lost their cost reduction mechanism (currency devaluation) but continued to embrace labor policies that kept their costs high relative to competitors. Consequently, labor costs in Greece, Italy, Spain, etc. are much less competitive than in Germany, and few businesses see these economies as attractive locations for new facilities. For example, Airbus depends on support from the French government, yet it will locate its new production facility in Alabama.

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**FIGURE 3: HOME PRICES LEAD CONSUMER SENTIMENT**

![Graph showing the correlation between home prices and consumer sentiment](image_url)
We believe that low-cost ECB funding, when combined with austerity plans already in place, should be sufficient to bring European budget deficits under control. Should Spain and Italy reach such an agreement, then European equity markets could soar, celebrating the virtual elimination of Spanish and Italian default risk as well as the potential for faster economic growth stemming from the required reforms.

The main risk to this optimistic view is that opposition to labor market reforms prevents Spain and Italy from reaching an agreement with the ECB, IMF, and other oversight bodies. The rise of extremist parties on both the left and right in peripheral European countries such as Greece and Italy illustrates these risks. The ECB’s offer to support Spanish and Italian bond markets allowed these countries’ borrowing rates to decline sharply, removing the immediate pressure to reach an agreement. So long as markets remain content with the offer of support and do not demand an explicit support agreement with the ECB, then Spain and Italy can enjoy the fiscal benefits of lower borrowing costs without incurring the political costs of economic reforms. Politicians may seek to prolong this “solution” as long as possible, keeping markets uncertain about long-term policies and therefore reducing potential economic and equity market gains in 2013.

If markets begin to worry that agreement will not be reached, rates could climb quickly back to levels that jeopardize Spain’s and Italy’s fiscal solvency. We believe that should borrowing costs rise, that will quickly push Spain and Italy to reach an agreement that authorizes ECB support for their bond markets—failure to do so could lead to default and the end of the euro. Thus far, when confronted with a choice of adhering to the requirements of the IMF and ECB, the electorates of troubled euro members such as Greece have supported policies and politicians that maintain their euro membership. This track record of success should persuade politicians to endure the inevitable protests and rioting that will accompany implementation of an oversight agreement.

**China: New Leadership and Hopes for a New Direction**

China’s economic miracle of the past 20 years has been driven predominantly by investment spending, mainly on infrastructure that facilitated the migration of more than 300 million citizens from farms to rapidly expanding cities. Expanding exports also supplemented economic growth for much of the past decade, but as China grew to become the world’s second-largest economy, its size relative to potential export markets brought an end to export-driven growth. China’s new leadership team hopes to transition from dependence on investment spending and exports to a more balanced economy in which consumer spending plays a larger role. Their predecessors supported this vision by allowing double-digit wage gains for much of the past five years and enhancing the social safety net.

Despite these policy changes, consumer spending has failed to improve from a low 36 percent of GDP (see figure 4). We believe this strategy will continue to fail until the extensive policies and economic structures that depress domestic consumption in favor of exports are dismantled.

Since consumption is not growing fast enough to offset decelerating export growth, China’s new leadership team must choose between allowing GDP growth to dip below the politically unpalatable level of 5 percent or finding alternative sources of growth. Embracing a renewed commitment to economic reform offers the best hope for China’s long-term future, in our view, but incoming President Xi Jinping and Premier Li Keqiang have reputations as cautious status quo politicians. With little evidence of imminent sweeping reforms, we believe that China’s new leadership will opt for the same old script of investment-driven growth. Ample opportunity remains for productive infrastructure investment (e.g., Shanghai hotels are among the most technologically advanced in the world, but guests must brush their teeth with bottled water), and we expect that the new leadership team will greatly increase the current $150-billion infrastructure initiative.

**FIGURE 4: CHINESE CONSUMERS OFFER A POTENTIAL SOURCE OF GROWTH**

![Chart showing Chinese consumer spending as a percentage of nominal GDP from 1978 to 2013.](chart.jpg)

*Source: Ned Davis Research*
“Few predicted that Jiang Zemin and Zhu Rongji would enact such bold economic reforms in the late 1990s and early 2000s, and even fewer predicted that reform efforts would grind to a halt under their successors.”

Although we anticipate that the new Chinese leadership team will opt for a cautious approach, we must acknowledge that outside observers often are surprised by the policies that follow China’s once-in-a-decade leadership transitions. Few predicted that Jiang Zemin and Zhu Rongji would enact such bold economic reforms in the late 1990s and early 2000s, and even fewer predicted that reform efforts would grind to a halt under their successors. A renewed commitment to economic reform by Xi and Li would be a big upside surprise to global financial markets, while any unexpected retreat from existing economic reforms (increased trade barriers, additional restrictions on foreign investment, etc.) could put further downward pressure on Chinese equity prices.

A Solution for U.S. Debt Problems
In their book *This Time Is Different*, economists Carmen Reinhart and Kenneth Rogoff argue that once a government’s debts become unsupportable, the government must resort to one of three debt-reduction strategies:

- **Default**: Simply refuse to repay the owed obligations (e.g., Russia in 1998, Argentina in 2000, Greece currently and for much of its existence).

- **Lower standard of living**: Endure higher taxes and fewer government services as debt obligations are repaid (e.g., Brazil and Korea in the 1990s, Portugal and Ireland currently).

- **Financial repression**: Print enough money to lower interest rates below the rate of inflation and keep rates there until debts are inflated away (e.g., the United States and Great Britain post-World War II, China in the 1990s, the United States and Great Britain currently).

Default or lower living standards typically occur only if the indebted country cannot print the currency in which it has borrowed. If the country owes its own currency, then depressing interest rates by printing more of that currency (financial repression) tends to be the least painful way to reduce excessive debt.

The Fed used its printing press to keep interest rates below the rate of inflation throughout the 1940s and early 1950s in response to the large debt burden left over from World War II. This financial repression strategy caused bond investors to lose between 40 percent and 50 percent relative to inflation. Importantly, losses of this magnitude were not reflected in the market value of bond portfolios (by keeping interest rates low the Fed prevented bond prices from falling). Rather, each year bond investors earned somewhat less than the rate of inflation and losing a modest amount every year for 14 years compounded the pain of purchasing-power losses.

The Fed had little choice but to inflict these purchasing-power losses on bond investors because rising interest rates could have caused the U.S. budget deficit to spiral out of control. The potential budgetary impact of rising interest rates on a highly indebted government was clearly illustrated in a recent Congressional Budget Office report: If the Fed allows short-term interest rates to rise to about 3.5 percent, the combination of rising interest rates and rising debt would add more than $1 trillion to the annual budget deficit by 2017.

We believe that this budget reality compels the Fed to emulate its post-World War II financial repression strategy. Should the Fed continue this strategy in the next few years, as much as half of the associated purchasing-power losses could be borne by foreign creditors such as the central banks of China and Japan. The ability to shift much of the cost of reducing U.S. debt burdens to foreign institutions may be an added incentive for the Fed.

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