

Indebtedness, the Commodity Super Cycle & Asset Allocation

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Summary:

With the heightened awareness of the level of indebtedness & the associated vulnerability of the financial systems of the US and other English speaking economies, many are forecasting a modern day, albeit less pronounced, re-run of the 1930s (i.e. debt deflation). At the same time and in clear contrast others are, with equal confidence, pointing to the 1970s as the appropriate template for the western economies (i.e. because of the run-up in oil & other commodity prices and associated inflationary pressures).

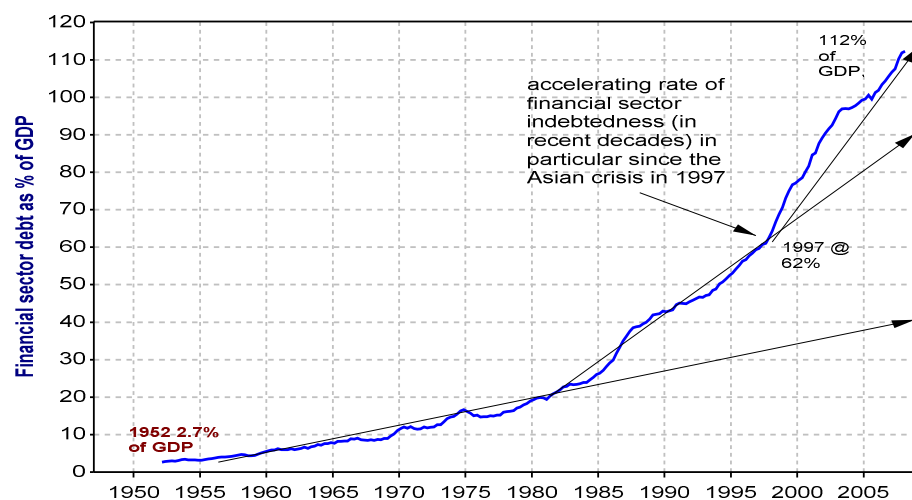
Determining which, if either is correct is critical with respect to asset allocation decisions, most notably with respect to government bonds as well as determining which economies, which sectors and which stock markets will outperform.

Our analysis, however, suggests that both templates are, in some respects, accurate. Indeed the backdrop to today's crisis encapsulates 2 major long term structural macroeconomic trends which were both present at the start of the 1970s and at the start of the 1930s. Those trends are:

- i) The beginning of the unwinding of the over indebtedness of the western, most especially English speaking, economies.
- ii) The commencement of the long term commodity super cycle 'upswing'.

The decades of the 1920s, the 1950s & 60s and the last decade (or indeed even further back since 1982) were all periods of steeply rising indebtedness in the US.

Fig 1: US financial sector indebtedness (1952 to 2008) – shown as a % of nominal GDP



Source: Longview Economics, Federal Reserve flow of funds, Reuters EcoWin

The level of financial speculation is illustrated by the rapid acceleration in financial sector indebtedness in the past 10 (& 25) years

Important disclosures are included at the end of this report

Household debt to GDP rose steadily from 24.0% in 1952 to reach a peak of 46% of GDP in 1965 – a 22 percentage points rise relative to GDP in just over 10 years. The rise in total economy non financial debt to GDP while significant was less notable (rising from 124% in 1952 to 139% by 1964). Financial sector indebtedness also rose during that time but from a trivial level of 2.7% of GDP to 8.8% (by 1966) – see figs 1 & 2.

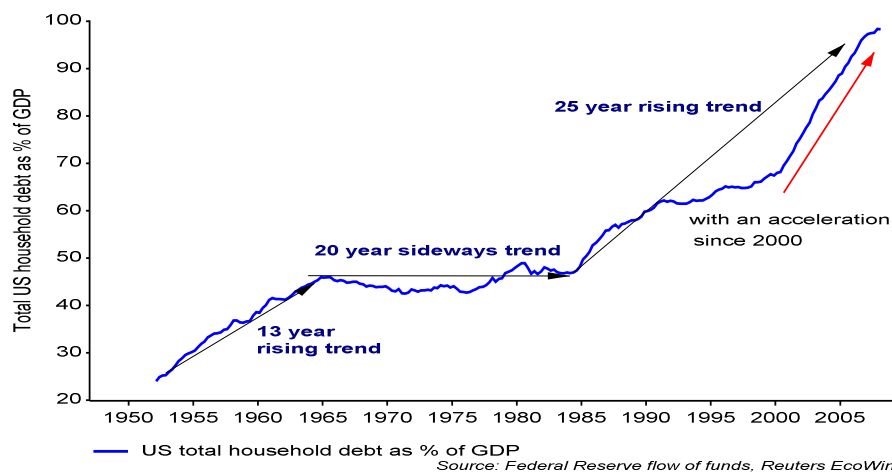
In the 1920s Wheelock reports that outstanding mortgage debt increased from under \$10 billion in 1920 to approx \$27 ½ billion by the end of the 1920s. Phillips reports that “Easy consumer and private mortgage lending...fed the boom by more than doubling from \$17.3 billion in 1922 to \$38.3 billion in 1929.” Household debt as a % of after tax income rose from 20% in 1919/20 to over 50% by the early 1930s before then retreating sharply during the next decade. Johnson writes:

“It was the stated policy of the Federal Reserve not only to ‘enlarge credit resources’ but to do so ‘at rates of interest low enough to stimulate, protect and prosper all kinds of legitimate business’ ”
 [In that passage Johnson quotes Seymour E Harriss: “Twenty Years of Federal Reserve Policy”1933]

The 1920s is also rightly renowned for its financial speculation (and commensurate rapid increases in financial debt). Galbraith devotes a whole chapter in his book “The Great Crash 1929” to the concept titled “In Goldman, Sachs We Trust”.

“During 1928 an estimated 186 investment trusts were organized; by the early months of 1929 they were being promoted at a rate of approx one each business day....in 1927 the trusts sold to the public about \$400,000,000 worth of securities; in 1929 they marketed an estimated three billions worth.....by the autumn of 1929 the total assets of the investment trusts were estimated to exceed 8 billions of dollars. They had increased elevenfold since the beginning of 1927.” – for further analysis see Longview Letter no 16 August 2007 “1920s: The Parallels to Today”.

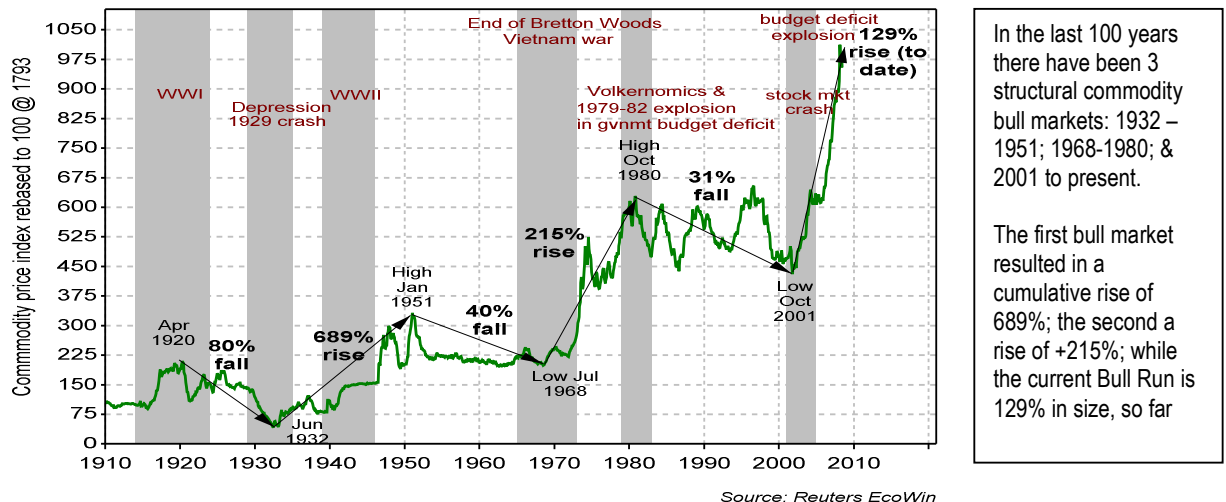
Fig 2: US Household debt to GDP (1952 – 2008)



All of those conditions have been present in the last decade. Household debt to GDP has risen rapidly from 68% of GDP in 2000 to 98% today (fig 2). Total non financial debt to GDP has increased by over 40 percentage points of GDP since the turn of the millennium. Over and above that, illustrating the level of financial speculation, financial sector indebtedness has almost doubled in the last decade (fig 1) – i.e. from 64% of GDP in 1998 to 112% today (also see credit intensity of GDP growth analysis “Structural vs. Cyclical” Longview Letter No 19 January 2008).

With respect to the second structural trend, as we detailed in “Commodity Super Cycle; Myth or Reality?” Longview Letter no 26 June 2008, structural commodity bull markets began at the beginning of all these decades, i.e. in 1932 (@ the end of the depression) in 1968 and in 2001 – arguably all in response to (eventual) loose monetary policy. The 1932 commodity bull market lasted until 1951 (i.e. 17 years) while the 1968 commodity bull market ended in 1980/82 – the shortest on record (i.e. since the 1750s).

Fig 3: The Commodity super cycle



The exact causes and drivers of the commodity super cycle are vigorously debated amongst academics and market practitioners. Professor Hackett Fisher alludes to 7 possible causal explanations including demographics, monetarism, and agrarian causes as well as long term weather patterns. Either way industrialisation clearly has its part to play. Today that is evidenced by the appetite for resources of China, India & other large emerging market economies (e.g. see “Industrialisation & Copper Demand Dynamics” April 2008).

Conclusion

Today’s economic predicament has parallels with both the US of the 1930s (i.e. debt deflation) and with the US of the 1970s (i.e. stagflation). In particular both periods were preceded by a decade (or longer) of rapid increases in indebtedness. Both decades also marked the start of a structural commodity bull market. Over the course of that commodity super cycle, both periods experienced structural bear markets in real terms in bonds and equities (i.e. over the course of the commodity super cycles – see section 1).

On closer examination, though, it becomes apparent that the parallels with the 1920s and 30s are more pertinent. Financial speculation was high in the 1920s while in the 1960 & 70s it was at a low ebb. Income inequality, which often goes hand in hand with financial speculation and financialisation of an economy, was also at an extreme in the 1920s, as it is today, while in the 1970s it was at record low levels. Finally the profit share of GDP was also at record highs in the 20s as it is today (and again at/close to record lows in the 70s).

Indeed the experience of the 1930s in many ways sowed the seeds for the 1970s. Unlike in the 1930s, the outcome of the commodity super cycle in the 1970s was a wage price spiral (NB in the 1930s

unemployment rose to 25%). That in large part reflected the organisation and unionisation of labour which had begun in response to the depression of the 1930s. Indeed the governmental response to the 1930s depression further reinforced those inflationary effects of the unionisation of labour. In particular the government responded to those crises with greater levels of protectionism (e.g. Smoot Hawley Tariff Act of 1930 which remained fully in place until the 1950s) and increased levels of regulation – most especially of banks and risk taking (e.g. Glass Steagall Act of 1933).

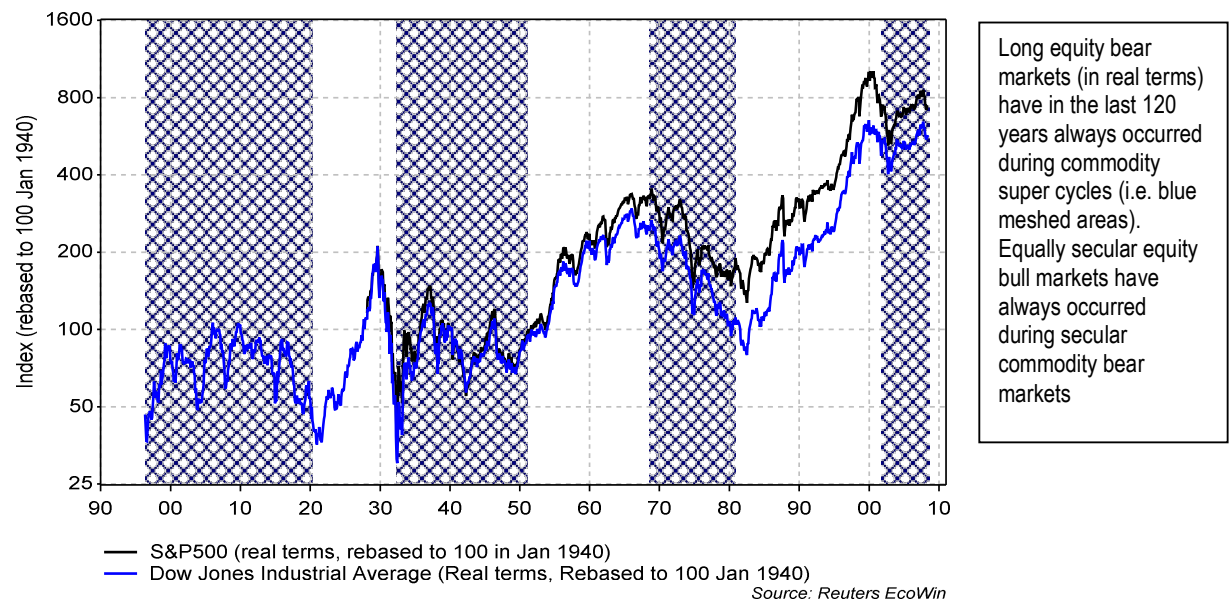
While today there is a rising level of desire to interfere with free markets (e.g. witness the protectionist rhetoric of the Democratic campaigning, the attempts to clamp down on speculators, the expressions of intent to regulate risk from the SEC and the Federal Reserve), it takes time to meaningfully unwind 25 years of deregulation (assuming that there is a desire to meaningfully unwind it). Currently therefore given the high levels of leverage and indebtedness in the system as well as the unwinding of the housing boom, the parallels with the 1930s and therefore concerns about short and medium term debt deflation would appear to be the most valid - most especially given the backdrop of a decade of financial speculation.

Section 1: Commodity super cycles & asset allocation

Whether the correct parallels are with the 1930s, the 1970s or some other time period, historically equities and bonds in real terms generate negative real returns over commodity bull markets. That is the evidence of the past 2 or 3 commodity bull markets.

From 1896 to 1920 in real returns equities delivered a zero return (fig 4). During the commodity bull market of 1932 to 1951, equities (in real terms) were close to flat (although relative to peak levels in the late 1920s, equities were considerably down over that time). From 1968 to 1980, equities almost halved. Since the start of this commodity bull market, equities are so far, approximately flat.

Fig 4: Real long term equity indices (US using S&P500 & DJIA, adjusted by US CPI)



Commodity Super BULL Cycles – shown in Blue mesh shaded areas

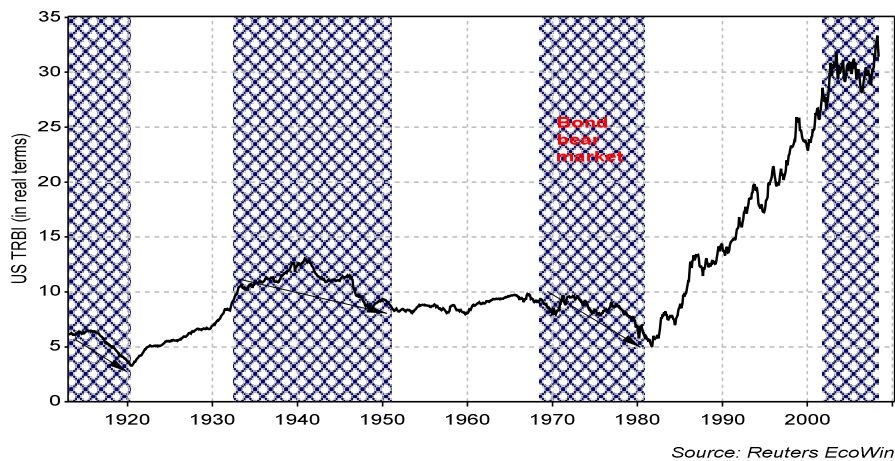
The same is also true of bonds, albeit the 1930s bond cycle was distinctive in its shape and pattern of performance from the 1970s bond cycle.

In the 1930s bonds initially rallied aggressively from the start of the commodities bull market (i.e. 1932), before then selling off over the course of WWII such that over the course of the commodity cycle cumulative real returns were negative.

In the 1968-80 commodity bull cycle, the real total return US bond index approximately halved and was essentially in a bear trend throughout that whole time period (see fig 5).

In contrast real returns on bonds since October 2001 (start of this commodity bull market) are positive, albeit modestly so.

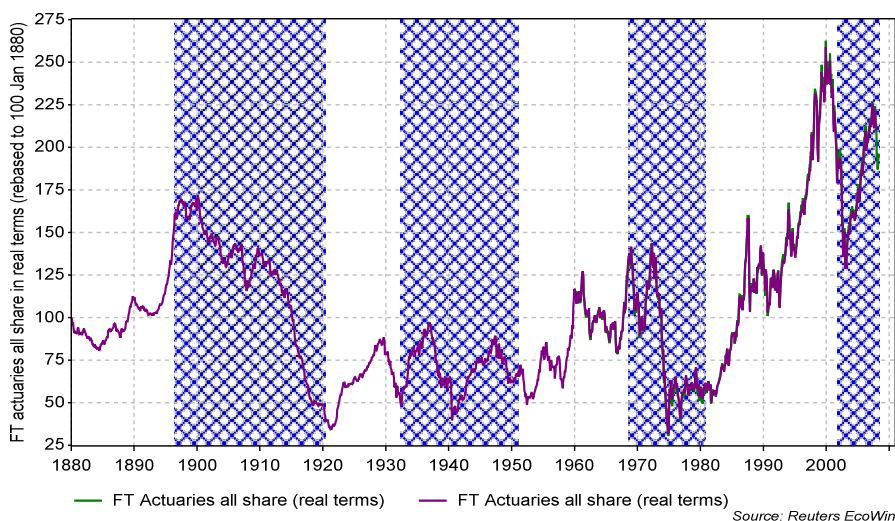
Fig 5: Real total returns in US bonds (shown with commodity bull markets in blue)



The inflationary pressures of commodity bull markets tend to generate bond bear markets (e.g. see 1968 – 80 & 1932 – 51). In the earlier 1930s example this is considerably less marked than in the 1970s. Indeed in the 1930s, reflecting poor economic growth and the debt deflation, bonds initially rallied markedly before suffering during WWII and its aftermath

Commodity Super BULL Cycles – shown in Blue mesh shaded areas

Fig 6: UK FT all share index in real terms shown vs. commodity super cycles (rebased to 100 in 1880)



UK equities also underperform significantly in real terms during commodity bull markets (& conversely outperform during commodity bear markets). Indeed the underperformance is typically more dramatic in the UK than in the US.

Commodity Super BULL Cycles – shown in Blue mesh shaded areas

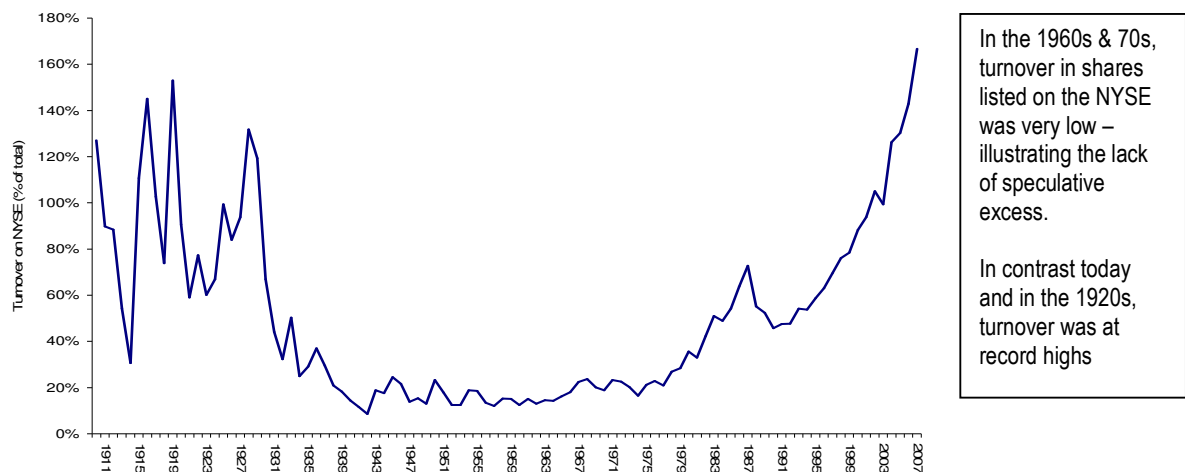
Section 2: The Breakdown of the similarities with the 1970s

If we take the analysis one stage further, though, we find that the similarities between today and the 1970s begin to breakdown while the structural similarities between today and the 1920s/1930s increase.

In particular while the 1960s is renowned as a 'go-go' equity market, it was not a period of excessive financial speculation. Financial sector debt as a % of GDP rose, but not aggressively (i.e. as it has today and as historical records of the 1920s suggest it did during that period). An analysis of the turnover of shares listed on the New York stock exchange shows that there was a low level of stock market activity in the 1960s and 70s with New York Stock Exchange turnover close to its lowest in the past 100 years (fig 7).

In contrast both current times and the 1920s have exhibited extremely high levels of activity on this measure. During the first 30 years of the 20th century turnover on the New York Stock Exchange would often register above 100% of outstanding shares (fig 7). Since the turn of this latest century, that high level of activity is again being repeated – indeed turnover last year (2007) reached its highest on record of 167% (above its prior record of 153% in 1919). Naturally this is indicative of the increasingly shorter term and therefore by definition, increasingly speculative nature of this market. Deregulation of credit and financial markets has (probably) been a key driving force behind this change in the last 20 – 30 years.

Fig 7: Turnover – NYSE (Shares traded divided by shares listed)



Source: NYSE

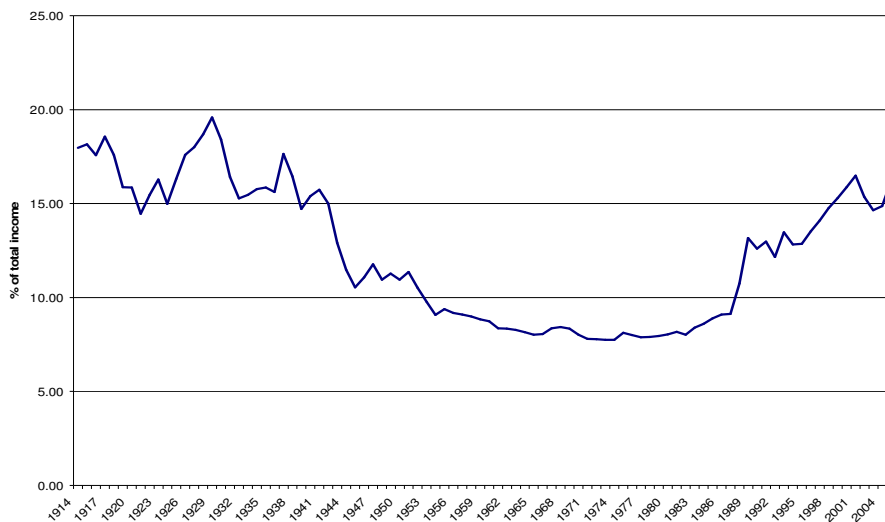
That high level of financial speculation in recent years and in the 1920s is also consistent with 2 other key contrasts between the 20s and the 70s:

i) In the 1920s income inequality was at an extreme – that is the highest earners took home a high share of total national income (i.e. approx 15 – 20% of total national income). After WWII both because of increasing levels of regulation as well as the Great Compression (i.e. progressive taxation policy) that share of income accruing to the richest 1% of Americans fell through to the late 1970s. Then under the deregulation of the economy, starting in 1980 with Reagan, coupled with the rolling back of progressive taxation (i.e. the Great Inversion) the share again started to climb such that by 2004 (the latest data point on our chart) it was back over 15%. Indeed the IRS reported this week that the richest 1% are now taking home 22% of the nation's income – highest on record (albeit there are some measurement

issues comparing today's data with the pre 1988 data). In both instances (today and the 1920s) a driver of that income inequality was financialisation and the "coupon clipping rentiers" Pinketty & Saez. (see Longview Letter no 14 April 2007: "Financialisation & Does Income & Wealth Inequality matter?" for further analysis).

ii) Second and related to point (i) above, the profit share of GDP in the 20s and today is at extremely high levels. That is consistent with extreme levels of income inequality and reflects the suppression of wages of the middle and low income workers (NB Median real wages in the 1920s and the last decade barely increased over each respective decade) – see "Globalisation, Plutocracy & the Profit Share" Jan '07 for analysis.

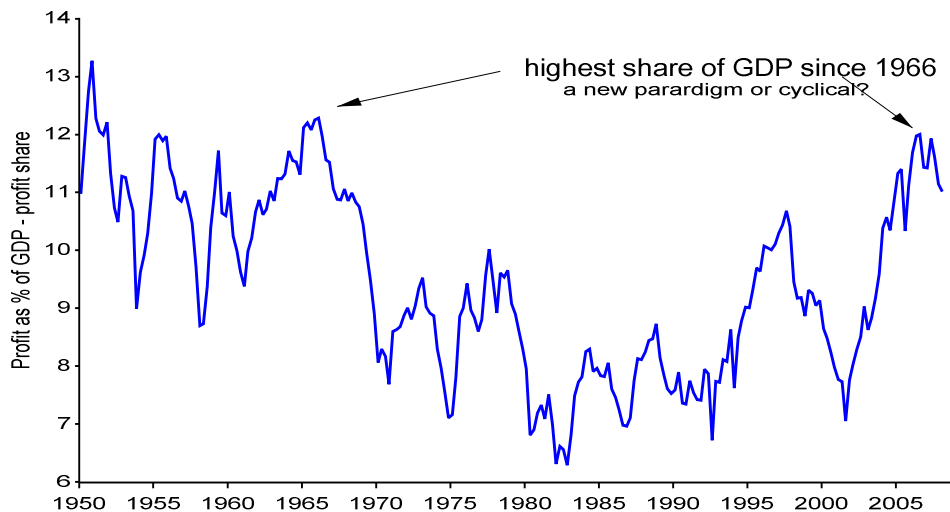
Fig 8: Income share of top 1% of US earners (i.e. as % of total US income)



Income inequality is back at extremes. The top 1% of US earners took home between 15 & 20% of total US income in the 1920s. The latest data on this chart shows that in 2004 the top income earners took home over 15% of national income. The latest IRS data shows that the ratio is now over 22%.

Source: Piketty & Saez

Fig 9: US corporate profit share of GDP (%)



Source: Reuters EcoWin

References:

- Phillips, K. Wealth and Democracy
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- Wheelock, David C. The Federal Response to Home Mortgage Distress: Lessons from the Great Depression, Federal Reserve Bank of St Louis Review May/June 2008
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