

Planning & Investment News

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DELEVERAGING

There seems to be two current investment philosophies dominating the economic landscape:

- 1) We are experiencing a "V" shaped recovery from the 2008 financial crisis. The markets, especially the emerging markets, will continue to perform well; or
- 2) The markets have recovered too fast, that high unemployment and debt levels will create huge headwinds to any continued market returns.

As written previously, we are in the second camp. A recent study done by well known global consultant McKinsey & Associates supports this view. The study analyzed forty-five historic episodes of deleveraging since 1930. *Deleveraging* basically means "getting out of debt". Several of the study's conclusions are:

- "...a long period of deleveraging nearly always follows a major financial crisis."
- "Historic deleveraging episodes have been painful; on average lasting six to seven years....GDP [a measure of the economy] typically contracts during the first several years and then recovers."
- If history is a guide, we would expect many years of debt reduction..., and this process will exert a significant drag on GDP growth."¹

Interestingly, middle-income households, not the financial sector, showed the largest increase in debt (I am reminded of warnings from Crown Financial's Larry Burkett).² As illustrated in our previous newsletter, debt in the U.S. has increased significantly since 1980. The global nature of this crisis differentiates it from most previous events. Debt levels exploded overseas in the last ten years.³

The deleveraging process has been delayed due to massive government borrowings across the globe. In addition to delaying the deleveraging process, these borrowings are predicted to prolong the recovery.⁴

¹ "Debt and deleveraging: The global credit bubble and its economic consequences", McKinsey Global Institute, January 2010, page 9 - http://www.mckinsey.com/mgi/reports/freepass_pdfs/debt_and_deleveraging/debt_and_deleveraging_full_report.pdf

² Ibid. page 24

³ Ibid. page 23

⁴ Ibid. page 44



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Several current events we are watching, imposed on this more long-term view, include:

1. The expected rise in foreclosures from so called "Alt-A" loans;
2. Disclosure of off-balance sheet entities of financial institutions soon to be required by accounting regulations changes;⁵
3. Economic policy changes in China; and
4. Economic issues in Portugal, Italy, Greece, and Spain (otherwise known as PIGS) and political issues in Iran.

Primarily due to the discussed issues, we remain conservative. We feel a moderate stance is the best posture to protect your hard-earned money. As always, we welcome your comments.

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⁵ "Green Shoots, Weak Roots", John P. Hussman (<http://www.hussmanfunds.com/wmc/wmc100111.htm>)