



Western Medicine

I was born in Ohio several years after my parents immigrated to the U.S. from India. Like many Americans of Indian descent, we have a lot of doctors in our family, no doubt the product of thoughtful 1960s immigration policies that prioritized certain in-demand skills. Medicine is the noblest profession in the Indian-American culture, because it is focused on helping others, requires intelligence and pays well. Sadly, finance isn't held in such high regard.

Mr. Kashkari is a managing director and head of global equities in the Newport Beach office. He also serves on PIMCO's Business Assessment Committee, and he is president of PIMCO Equity Series Trust. Previously, he was head of new investment initiatives for the firm. Prior to joining PIMCO in 2009, Mr. Kashkari served in the U.S. Treasury Department from 2006–2009, first as senior advisor to Secretary Henry Paulson and then as Assistant Secretary of the Treasury. In the latter role, he established and led the Office of Financial Stability and oversaw the Troubled Assets Relief Program (TARP). Before joining the Treasury Department, Mr. Kashkari was a vice president at Goldman Sachs in San Francisco, advising technology companies on financings and mergers and acquisitions.

Having grown up around doctors I learned to marvel at the progress of modern medicine. New treatments using the latest technologies are being developed every day. People are living longer, healthier lives.

Surprisingly, not everyone is as enamored with this medical progress. In fact, some people make a strong distinction between "Western medicine" and "Eastern medicine." What's the difference, you may ask?

Critics say that Western medicine is focused on treating symptoms to make people feel better once they become sick while Eastern medicine is focused on healthy living, prevention and living in balance. Take the common cold: We still don't have a cure for it. We have decongestants that make our noses less runny. But they don't do anything to actually cure the cold. Or there's aspirin, which can help bring down a fever. Once again, it buys time – makes us feel better – but doesn't cure the underlying disease. Eastern medicine is said to focus on understanding why we became sick in the first place and preventing it in the future.

When I needle the doctors in my family with these criticisms of Western medicine they bristle in response. How could I possibly question the wisdom of their profession? They are scientists! When pressed further, some will eventually admit that if science hasn't yet found a cure for a disease, relieving symptoms is better than nothing.

Have we really cured the disease that has afflicted the U.S. economy, or have we merely been treating the symptoms?

This conflict between Eastern and Western philosophies isn't limited to medicine. We are living through it every day in global economics, policy and financial markets.

Consider insolvency. Banks (and countries) fail due to a lack of liquidity – running out of cash. But running out of cash is merely a symptom of the real problem: too little capital, too many losses and too much debt. The European Central Bank has flooded the European banking system with euros via its Long-Term Refinance Operation (LTRO). This almost unlimited source of cash takes the risk of default for a European bank virtually off the table. But, by itself, it does nothing to cure the underlying disease: Banks have a lot of debt on their balance sheets that they once believed were riskless and now realize are in fact risky – namely the sovereign debt of several European countries. While these European countries may also be more stable in the short term due to the ECB's various direct and indirect liquidity programs, their underlying sickness is that they too have taken on too much debt; their societies are spending more than they can afford and their economies are growing too slowly to support their debt loads. Liquidity is buying them time. It is a bridge. A decongestant is a bridge that makes us feel better until our immune system can cure the disease. To what actual cure are these European liquidity programs a bridge? We don't know.

Here in America our policymakers have also been forced to reduce symptoms rather than cure the underlying disease – because that disease is a 30-year addiction to debt-fueled consumption and we don't know how to quickly create new, sustainable engines for economic growth. As a result, most economic policy in the U.S. in the past three years has bought time by supporting consumer spending.

Consumption makes up by far the largest share of economic activity in the U.S. If consumption spending fell, the U.S. economy could face another serious recession. Hence policies such as the stimulus, Cash for Clunkers, payroll tax holidays and even the Federal Reserve's low rates and quantitative easing have been supporting consumer demand. Figure 1 shows the enormous role that consumption plays in the U.S. economy, growing from about 62% of GDP in the 1960s to over 70% today.

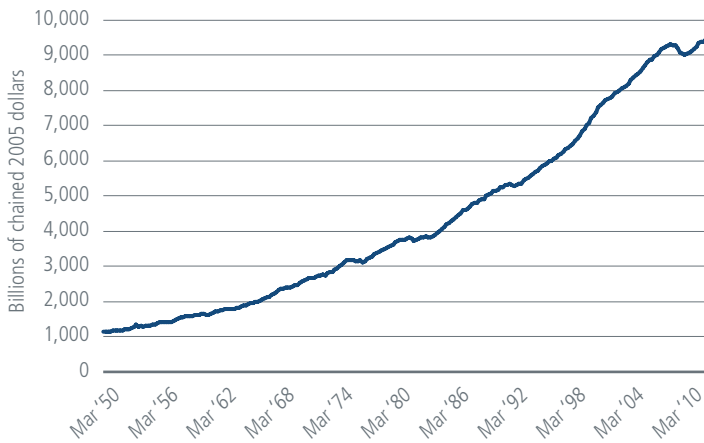
As a result of aggressive government policies, consumption has bounced back to pre-crisis levels, as shown in Figure 2. Many economists are celebrating the strengthened U.S. consumer as the force behind a remarkable rebound so soon after the worst financial crisis since the Great Depression. This would suggest aggressive government stimulus policies have been effective and the economy has almost returned to normal.

FIGURE 1: PERSONAL CONSUMPTION EXPENDITURE AS A PERCENTAGE OF U.S. GDP



Source: Haver, Bureau of Economic Analysis; data as of September 2011

FIGURE 2: REAL PERSONAL CONSUMPTION EXPENDITURES IN THE U.S. (SEASONALLY ADJUSTED ANNUAL RATE)



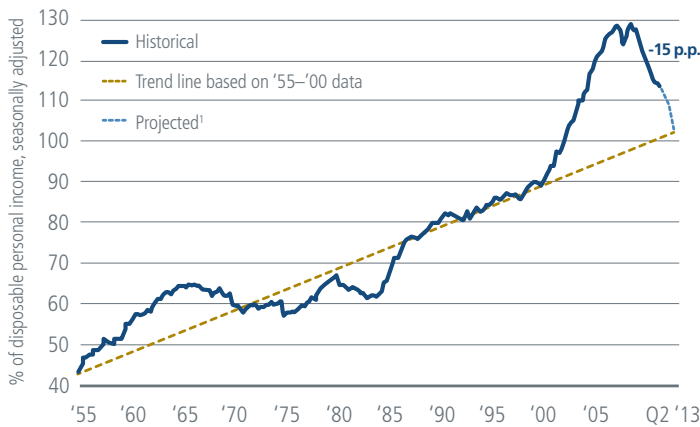
Source: Haver, Bureau of Economic Analysis; data as of September 2011

But is this the whole story? Have we really cured the disease that has afflicted the U.S. economy, or have we merely been treating the symptoms?

Last month the McKinsey Global Institute published a research report (“Debt and deleveraging: Uneven progress on the path to growth”) trying to answer this question by analyzing the deleveraging that countries have undergone since 2008. McKinsey sought to understand how much deleveraging has been completed and how much is left to work through the system, because once the deleveraging phase is behind us, the U.S. economy may resume its growth trajectory. McKinsey argues the U.S. is far ahead of other countries in deleveraging, and that U.S. households will soon return to a sustainable debt level.

As discussed previously, given that consumption represents more than 70% of U.S. GDP, this is an important estimate that will affect our economic growth in the next few years. Figure 3 is a graphic from the McKinsey report that shows U.S. household debt as a percentage of disposable personal income. It indicates that Americans have less debt than they had in 2008. This trend leads to McKinsey's estimate "that U.S. households could face roughly two more years of deleveraging. ... One possible goal is for the ratio of household debt relative to disposable income to return to its historic trend."

FIGURE 3: THE U.S. HOUSEHOLD DEBT RATIO COULD RETURN TO ITS LONG-TERM TREND IN 2013



¹This is based on estimates of the foreclosure pipeline in Q2 2011 and ignores future growth in disposable income.

Source: U.S. Federal Reserve; CoreLogic; Haver Analytics; McKinsey Global Institute

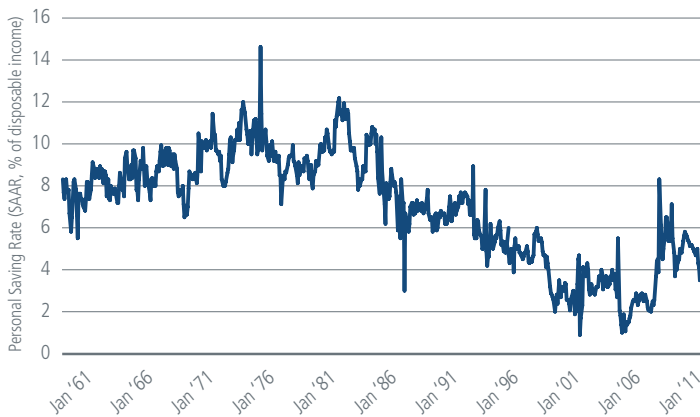
But why should the trend be upward sloping at all? According to the McKinsey chart, in 1955 household debt to disposable income was about 45%. McKinsey says household deleveraging should be completed by mid-2013 when Americans "only" have debt to income of 100%.

Why should Americans each year take on more and more debt? Is this sustainable? Is this a good trend for Americans and for the U.S. economy? McKinsey acknowledges these questions – but doesn't change their conclusion that U.S. deleveraging is on track and the American consumer is almost back.

To look deeper behind the increased consumption numbers, one must look at how much Americans are actually saving. As Figure 4 indicates, from 1960 to the mid-1980s, Americans saved more than 8% of their income each year. Then savings began to fall – and fell almost to zero just before the crisis in 2008. In fact, by some measures, Americans on average had a negative savings rate in the mid-2000s. They were consuming with borrowed money, often by taking out home equity loans. The shock of 2008 scared many Americans into saving more. They realized their home values wouldn't climb forever and they needed to save for their futures. The personal saving rate climbed back to almost 6%, still lower than all the years from 1960 to the mid-1980s, but a more financially sound level than the years immediately before the crisis.

Alarming, this healthy increase in savings appears to have been short-lived: Consumers have actually started saving less in recent quarters and *this* has fueled much of the recent uptick in consumption.

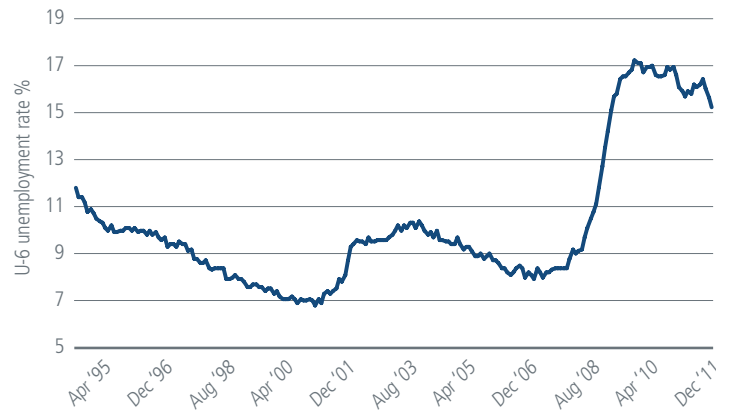
FIGURE 4: PERSONAL SAVING RATE (SEASONALLY ADJUSTED ANNUAL RATE)



Source: Haver, Bureau of Economic Analysis; data as of November 2011

Of course, this lack of savings is also happening at a time when millions of Americans are without work. The personal saving rate in Figure 4 ignores the millions of people who are without a job, and obviously cannot save anything. It only considers how much of the income earned by people who are working is being saved. Figure 5 shows the “U-6” unemployment numbers: Roughly 15% of Americans are either currently looking for work or have dropped out of the workforce and have given up altogether.

FIGURE 5: U-6 UNEMPLOYMENT RATE



Source: Haver, Bureau of Labor Statistics; data as of December 2011

When will we know that the U.S. economy has really cured its underlying disease of relying too much on household debt to artificially drive its growth? *We will know it when overall consumption dollars continue to climb while the unemployment rate falls, the savings rate remains high and consumption as a percentage of GDP stays flat (or even falls).*

Increased consumption spending fueled by more Americans working (and saving) is a good thing and should be a goal of policymakers. Consumption fueled by temporary stimulative policies or reduced savings is just a nasal decongestant. It makes the headline economic data look better, but doesn't move us closer to actually healing our economy.

So what does all of this mean for equity investors?

Until we see sustainable, real economic growth here in America, we believe equity investors should consider high quality global companies with strong balance sheets that are selling into higher growth markets.

Investors should carefully scrutinize the assumptions underlying consumer discretionary stocks. Markets are used to assuming companies and industries can automatically return to trend growth once an economic shock has passed. Just as there is no reason to assume household debt levels will continue to climb, there is also no reason to assume companies that benefitted from that debt-fueled spending will grow at historical rates. The U.S. auto sector is a good example: The current recovery in auto sales is both a combination of replacement demand and increased loan availability. But if the American consumer is secularly impaired (or perhaps *liberated* from the weight of ever-increasing debt), total car ownership per household could decline in the long run, limiting the scope for a rebound. Resuming peak sales in the 18 million units range will likely take a long time, driven by population growth rather than household debt.

Bottom line diagnosis: Nyquil may be the nighttime, sniffing, sneezing, coughing, aching, stuffy head, fever, so you can rest medicine – but you might still wake up with a cold.



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840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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