

## Life in the Time of Debt: Opportunities and Risks in an Age of Global Rebalancing

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### Executive Summary

During the global financial crisis and recession of 2007-2009, governments across the world expanded their balance sheets to compensate for the collapse in private spending and credit creation. As a result, public sector debt in many developed countries has risen to historic proportions. Meanwhile, many households and businesses continue to struggle with their own debt burdens resulting from the collapse in property prices and a boom in leveraged buy-outs. This debt hangover is expected to weigh on governments and their constituents for many years to come, particularly as debt payments are added to out-year liabilities associated with healthcare and retirement spending. The debt burden is also expected to dampen growth possibilities and potentially lead to greater uncertainty and volatility in global capital markets. To understand the implications of this macroeconomic backdrop for investors, BNY Mellon Asset Management recently spoke to investment professionals across our global boutiques to get their independent perspectives.

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### SETTING THE SCENE

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We trace the evolution of the historic build-up of debt in the developed world, surpluses in the emerging world and the destabilizing influences that might affect economies and markets as a result of the rebalancing process.

### TRANSLATING DISEQUILIBRIA INTO VALUE OPPORTUNITIES

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Jamie Lewin of BNY Mellon ISSG<sup>1</sup> distinguishes between the effects of deleveraging on the real economy and the potentially attractive capital market opportunities that might still be captured in that environment. He points out the long-term positive effects deleveraging might have on both economies and capital markets by producing greater fiscal discipline and reducing the likelihood of negative market shocks associated with large debt overhangs.

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<sup>1</sup> Investment Strategy and Solutions Group (ISSG) is part of The Bank of New York Mellon, a principal banking subsidiary of BNY Mellon.

**CAN EUROPE SUCCESSFULLY DELEVERAGE?****PAGE 5**

Paul Brain of Newton<sup>2</sup> argues that if the three smaller troubled economies of Greece, Ireland and Portugal can obtain cheap funding over the next three years to work through their debt problems and if Spain and Italy can avoid major bail-outs, then there might be light at the end of the tunnel for the Eurozone. He points to the current divergence in monetary policy between the ECB and the Fed as a potential source of risk for government bond markets.

**REDRESSING THE BALANCE BETWEEN DEVELOPED AND EMERGING WORLDS****PAGE 8**

Standish<sup>3</sup> Global Macro Strategist Thomas Higgins relates the debt overhang in the developed world to the surpluses in the emerging world and describes why a gradual shift from an export-driven to a more domestic consumption-driven growth model in emerging countries like China will be good for the global economy. He also warns of the necessity for the developed world to address its more serious long-term debt problems in addition to operating deficits.

**CREDIT CYCLES AND THE U.S. EXPERIMENT IN QUANTITATIVE EASING****PAGE 10**

The Boston Company's<sup>4</sup> CEO David Cameron looks at credit cycles over time and describes the U.S. policy of low interest rates and stimulus spending as a bold experiment that might be feeding smaller bubbles and crashes around the world and setting the stage for rising inflation at home.

**PICKING YOUR SPOTS IN A SHIFTING MARKETPLACE****PAGE 13**

Mellon Capital's<sup>5</sup> President Alexander Huberts argues that the global process of deleveraging and rebalancing affects nearly all asset classes but not in a uniform way. He describes the current environment as conducive to global macro investors who can be nimble and flexible in picking what they consider to be the best asset classes and best regions at any particular time.

**SHRINKING MARKET CYCLES****PAGE 15**

Charles Dolan, Chief Strategist for BNY Mellon Asset Management's Fixed Income, Cash and Currency Group,<sup>6</sup> believes we are in an environment in which pools of capital have become larger and institutional investors hungrier for return to satisfy pension obligations or stock up rainy-day funds in the case of some sovereign wealth funds. This "roving global capital," he says, is shortening the market cycle, with mini bubbles and crashes occurring more frequently. Flexible investors with long time horizons, he says, are likely to reap the potential benefits.

**BACK TO THE FUTURE: EQUITIES REGAINING FAVOR****PAGE 16**

BNY Mellon Asset Management Chief Investment Strategist Phillip Maisano believes deleveraging in the U.S. will reduce borrowing demand and keep interest rates low, with implications for the relative attractiveness of equities versus bonds. He argues that equities are likely to draw more capital because of their enhanced yield potential and inherent inflation protection, reverting to how investors perceived equities 40 years ago.

**CONCLUSION****PAGE 19**

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<sup>2</sup> - <sup>6</sup> Please see disclosures at end.

## Setting the Scene

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While experts continue to debate the exact causes of the global financial crisis and recession of 2007-2009, there is general agreement that unsustainable global imbalances arose from nearly three decades of low interest rates and easy credit. These conditions led to historic spending and debt levels in the developed world at the same time that the emerging world, notably China, ran up enormous trade surpluses and savings rates. When the credit bubble burst in 2008, private demand collapsed, prompting governments across the developed world to step into the breach with massive injections of fiscal and monetary stimulus. This in turn drove up public debt levels to historic levels, as the private sector debt crisis spread to the public sector.<sup>7</sup> The OECD<sup>8</sup> estimates that total industrialized country public sector debt will exceed 100% of GDP in this year, an unprecedented state in peacetime.<sup>9</sup> More worrying, though, to many experts are the structural deficits expected to add to the debt burden as aging populations in the developed world drive increased public spending on healthcare and retirement benefits. According to the Bank for International Settlements, the projected debt/GDP ratios for a number of developed countries are on course to rise dramatically by 2020 unless fiscal policy changes or age-related spending is cut: projections are more than 300% of GDP in Japan; 200% of GDP in the U.K.; and 150% of GDP in Belgium, France, Ireland, Greece, Italy and the United States.<sup>10</sup>

Meanwhile, much of the emerging world was able to bounce back quickly from the global financial crisis and recession precisely because of their healthier balance sheets (having already experienced their own debt crises in the 1980s in Latin America and the 1990s in Asia). But many of those countries are dealing with destabilizing influences of their own. As growth continues apace, rising food and energy prices are stoking inflation. More fundamentally, countries like China are reaching the limits of their traditional export-driven models of growth in which they pegged their currencies to the U.S. dollar and accumulated enormous trade surpluses. That dollar peg has also meant they are tied to U.S. monetary policy, the easy nature of which is increasingly inappropriate for their rising inflation environments. Resetting the emerging market (EM) model to a more domestic-consumption-oriented approach that keeps inflation under control and allows for a gradual appreciation of local currencies is likely to require a balancing act of similar delicacy to the developed world's attempt to reduce debt without falling into a deflationary spiral.

What might this precarious macroeconomic background mean for investors? Some analysts have painted a decidedly gloomy picture of persistent subpar growth over many years and relatively meager returns from markets lurching from bad news to less bad news. Others see return opportunities precisely in the volatility such conditions might create. This is the context against which BNY Mellon Asset Management investment professionals comment on the future of markets and economies in an age of global deleveraging, rebalancing and resetting.

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<sup>7</sup> See Edward Ladd, "The Private Sector Crisis Is Going Public," BNY Mellon Asset Management, May 2010.

<sup>8</sup> Organization for Economic Cooperation and Development.

<sup>9</sup> Stephen G. Cecchetti, M.S. Mohanty, Fabrizio Zampolli, "The Future of Public Debt: Prospects and Implications," Bank for International Settlements Working Papers, March 2010, p. 1.

<sup>10</sup> *Ibid.*, p. 9.

# Translating Disequilibria into Value Opportunities

**Jamie Lewin**

**Director**

**BNY Mellon Investment Strategies and Solutions Group**

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We may see greater austerity-induced pain and heightened volatility in the near term, but deleveraging itself should ultimately strengthen the macroeconomic backdrop for capital markets.

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I believe it is important to distinguish between what could happen in the real economy as a consequence of debt deflation and the capital market opportunities it might create. The process of deleveraging is likely to have a dampening effect on consumer spending and GDP growth, but that does not necessarily translate into a low return environment for active investors.

Deleveraging requires a policy response from governments as well as a decision by households to strengthen their balance sheets. So while potential growth might be lower as a consequence of deleveraging, improving debt/asset ratios should, all else equal, reduce the likelihood of a deep recession or the variability of growth, because the leveraging effect, which can make growth spike and drop excessively, is likely to gradually dissipate.

Investors like certainty. So even if growth is lower, if investors believe the range of macro outcomes is now somewhat narrower and the volatility of GDP is lower, risk premia for economically sensitive assets do not necessarily have to rise. Investors tend to value relative certainty as well as the actual level of growth. An important part of the risk premium is not about the level of future cash flows but the variability of those cash flows. One could argue that of the two main drivers of equity returns, the growth component may be below trend, but a lower risk premium due to greater certainty could offset that, leading to a possible rerating of equities.

This deflationary growth environment may well be adding a measure of much needed fiscal discipline. Having the U.S., Japan and Europe confront their long-term debt crises might reduce the likelihood of future negative shocks associated with excessive levels of debt. We may see greater austerity-induced pain and heightened volatility in the near term, but deleveraging itself should ultimately strengthen the macroeconomic backdrop for capital markets.

It is also important to note that those gloomy growth prospects for the next few years do not credit possible improvements to productivity, and therefore growth, from technology- or labor-based innovation. In any case, we are already seeing growing signs of recovery in the U.S. in the form of a gradual lowering of unemployment, a gradual increase in manufacturing activity and spreading improvement in the services sector. The small business surveys have just started picking up. At the same time, it is clear that there are still a number of headwinds for the U.S. employment situation. As for continued problems in the U.S. housing market, we have already seen the housing crisis impact on asset prices. From now on, I believe the story of housing will be about how the overhang affects the real economy in terms of weighing on private consumption and the construction industry.

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The second half of this year will be interesting for the U.S. economy as the Federal Reserve ends its asset purchases under the second round of quantitative easing (QE2). The U.S. economy is still full of growth steroids at the moment, but as the fiscal stimulus fades, the question is whether the growth we've seen so far can be self-sustaining. There has been talk of a possible additional round of quantitative easing; I believe that would be a very bearish signal for markets. QE3 would essentially mean that QE2 did not work, that the monetary transmission mechanism has broken down and the Fed has become ineffective. That for me could translate into a classic liquidity trap reminiscent of Japan's struggles. The risk is that rather than addressing the structural problems in the economy, you continue to pump money into the problem and artificially stimulate growth over a short time period in the vain hope that you will eventually achieve a self-fulfilling recovery.

But the debate rages on over continued stimulus versus austerity as the appropriate response to the current environment, as we saw at the Davos meeting of world leaders earlier this year. Britain has taken a calculated risk and decided to take its austerity medicine now, though the Cameron government is aware of the potential problems this could create. Even though the average maturity of the U.K.'s debt is 15 years into the future, the government felt it had to signal to the markets that it was attending to its debt problems now. If they continued to fund themselves further out on the curve, their funding rates might soar once it came time to roll the debt over. To prevent the yield curve from steepening dramatically and having to pay 150 or 200 basis points more than the government currently pays, they felt they had to show markets their deleveraging resolve today.

But the U.K., like the U.S. and other highly indebted developed countries, is faced with the same challenge of trying to get its debt problem under control without completely choking off growth. Amid these prolonged, depressed-relative-to-trend levels of activity, I believe we will have heightened market volatility until we see some clear plan for resolving the structural debt problems. In that kind of environment, I believe investors need to embrace that volatility through active management in all its guises. If investors are able to look through the noise and discern general signals from all this uncertainty, I believe there is significant opportunity to translate the current disequilibria into great value opportunities.

## Can Europe Successfully Deleverage?

**Paul Brain**  
**Head of Fixed Income**  
**Newton**

For Europe, getting its debt to GDP levels from where they are now to more manageable levels will involve a number of years of extreme hardship and wage deflation. The problem, as I see it, is that there is not very strong political leadership to execute those difficult changes. On the contrary, we are seeing a breakdown in many political structures in Europe, with governments recently ousted in Ireland and Portugal.

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In the near term, the focus is trying to provide cheap funding over the next three years for the three smaller, beleaguered countries of Ireland, Greece and Portugal to work through their debt problems. When the crisis first struck, the European Central Bank (ECB) opened up its balance sheets to the European banking system, especially to Ireland's banks. As a result, the ECB balance sheet expanded far faster than that of the Fed or the Bank of England. Fears that that liquidity might be taken away then led from one period of credit spread widening to another.

The second stage was to set up the European Financial Stability Facility (EFSF) last year to provide emergency funding for countries like Ireland or Portugal. Because Greece's difficulties started earlier, there was a separate structure created to help them. The EFSF was hastily prepared and therefore imperfect, but the hope is that it can address the most serious problems facing the three smaller troubled countries over the next three years, until a more permanent facility is established. The European Stability Mechanism (ESM) is scheduled to launch in mid-2013. Any Eurozone country issuing debt after 2013 will have clauses built into its bonds that will automatically allow for restructuring or for a higher cost to be applied if that country uses the ESM. The European authorities hope that the worst of Ireland, Greece and Portugal's problems can be resolved by then, within the six to eight year period generally expected for recovery after a major financial crisis.<sup>11</sup>

Spain and Italy, which are coping with significant debt burdens of their own, have so far escaped the recent credit spread widening as the market is distinguishing between them and the three smaller countries that will most likely continue to require funding lifelines. If Spain needed to draw on the EFSF, the funds would be used up quickly because of the extent of its debt.

Spain is still in a precarious situation with both its housing sector and banking system. The Spanish authorities have set aside money to recapitalize many of the banks that exist solely to provide commercial and residential mortgages, but we do not know when those non-performing loans will come to market. Despite two rounds of stress tests for European banks, bank exposure to sovereign debt has not been included, so the level of that exposure is still quite opaque. It is difficult to know to what degree European banks have marked to market many of the sovereign securities on their books.

There are still a number of very difficult issues for Europe, but I believe the longer cheap funding can be provided, the better the chances of successfully working through these issues. We could see light at the end of the tunnel if Ireland, Greece and Portugal renegotiate their debt. That would be in the form of a voluntary restructuring, with creditors taking a haircut on their investment without bringing the European banking system to its knees. Many European banks, especially in Germany, have significant exposure to Irish, Greek and Portuguese debt.

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<sup>11</sup> See, for example, Kenneth Rogoff and Carmen Reinhart, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press), 2009.

Meanwhile, there are encouraging signs in the Eurozone's real economy. Growth is positive though below trend overall. Growth numbers in southern Europe are likely to be depressed for at least another 12 months, though we might see a lifting of growth in countries like Spain. If individual countries are able to produce positive growth, the markets will likely be prepared to give them the benefit of the doubt. Greece, Ireland and Portugal are unlikely to be issuing bonds for a while, but if the markets believe Spain and Italy can survive without Eurozone support, then the European bond market may recover. Europe might become a less stressed area to invest, with less anxiety every time a new government bond auction occurs.

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I believe the main risk in the near future is what will happen as the ECB continues to nudge up interest rates this year. It wants to raise short-term interest rates to tame inflation pressures. We see business survey data in northern Europe reaching new highs and growing export demand from the developing world. But if those short-term rates rise at the same time that long-term borrowing costs for the three weaker Eurozone countries are coming down sharply, the net effect for those countries might be limited. In my view, many investors are still worried about that first round of hikes. I believe the ECB will probably raise interest rates only a further 25-50 basis points, because the euro could rise quite substantially in the wake of larger rate increases and also the weaker peripheral European economies could be very negatively affected by much higher rates. That possibility, as well as remaining fears about austerity measures potentially leading to a double-dip recession, might limit the ECB's actions.

I think the divergence in monetary policy between the ECB and the Fed could create risks for bond markets. If the ECB is raising rates and the Fed is not, that could lead to significant changes in the currency and bond markets. Historically that kind of divergence has led to heightened volatility in risk assets and in government bond markets. As a result, I believe it is going to be very choppy in the bond markets for the next few years.

In my opinion, that is potentially a good return opportunity for global bond managers because there are different trends we can seek to exploit. I believe the debt overhang will continue to dampen people's investment plans. A certain amount of crowding out and uncertainty over how the debt gets refinanced will affect how much capital is put at risk.

Beyond Europe and the rest of the developing world, we are more optimistic about world growth numbers because emerging markets will continue to provide some source of demand, albeit with bumps along the road. I don't believe inflation in the developed world is a significant risk because we aren't seeing wage inflation. However, it is an issue in the developing world. In terms of global growth, I believe how the developing world responds to inflation and its currency issues will be more important than how the developed world deals with its debt overhang. For me, the important global story is about emerging markets continuing to lead the way rather than developed markets dragging things down.

# Redressing the Balance Between Developed and Emerging Worlds

**Thomas D. Higgins, PhD**

**Global Macro Strategist**

**Standish Mellon Asset Management Company LLC**

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For me, the deficits in the developed world and the surpluses in the emerging world are all related. I believe we will see a gradual process of rebalancing over the next 10 years or so, with an incremental appreciation of emerging currencies working to resolve historic EM surpluses and increased savings in the U.S. helping to reduce the debt overhang.

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For me, the deficits in the developed world and the surpluses in the emerging world are all related. I believe we will see a gradual process of rebalancing over the next 10 years or so, with an incremental appreciation of emerging currencies working to resolve historic EM surpluses and increased savings in the U.S. helping to reduce the debt overhang. The emerging world has been building up reserves ever since the financial crises of the last 30 years took such a toll on their economies, whether it was Asia in the late 1990s or Latin America in the 1980s. Those crises encouraged EM economies to build up reserves and focus on an export-oriented growth model. That model encourages keeping currencies artificially low so that exports are more attractive to overseas buyers. But I believe many emerging countries are reaching the limits of that model, which evolved when they were at lower stages of development with lower incomes, essentially lending money to developed countries like the United States. But that combination is not sustainable over the long run, partly because the emerging world has outgrown that approach, but also because the developed world has run up against the limit of how much borrowing can be done by advanced economies.

Whether emerging consumers like the Chinese can completely fill the spending gap left by tapped-out American consumers is an open question, but we are already seeing increased consumer spending in China as wages rise. Chinese retail sales are increasing at double-digit pace, but it takes time to develop private consumption when you are starting from such a low base. Private spending in China comprises 35% of GDP versus 70% in the U.S.<sup>12</sup> For the Chinese people, consuming more as they acquire more income is likely a better way to grow. I believe you end up with a happier population when you reach that stage of development, even if the recent consumer excesses in the U.S. might provide a cautionary counterexample.

But the Chinese continue to have far higher savings rates than in the developed world, at 40% of Chinese GDP, partly because China lacks social welfare programs like healthcare and retirement subsidies. Still, a major part of the Chinese government's 10-year plan is to support more of a consumption-driven growth model, as it recognizes the limits of the export-driven growth model. The government has even allowed some of the larger banks to introduce credit cards to encourage consumers to buy large consumer goods like washing machines and televisions on credit.

Part of that shift may also involve letting the renminbi appreciate. But as with any discussion of China, we always need to be mindful of the much larger scale we are talking about. For example, China has 20 million people entering the workforce per year compared with the entire working population in the U.S. of 140 million.<sup>13</sup>

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<sup>12</sup> World Bank statistics as of April 2010. See also "China to Boost Private Spending in a Plan to Boost Consumption," *Bloomberg News*, August 17, 2010.

<sup>13</sup> International Labor Organization as of April 2010.

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Global rebalancing will be a steady, multi-year process, but I think there are likely to be disruptions along the way.

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Transitioning from an export-oriented model to a consumption model overnight is just not possible. So for the moment they are keeping their peg to the dollar, which gave them stability and allowed them to export goods more readily to countries like the United States. But they are reaching the limits of that policy now, amid rising inflation pressures. The peg to the dollar means they also import loose U.S. monetary policy, which is inappropriate for an economy that is growing close to 10% a year.

I believe currency appreciation will continue, but it will be a gradual process over many years. Another complicating factor is that what China does with its currency has implications for other countries in Asia that compete against China or compete to sell into China. So it is not just China anchoring its currency to the dollar, but South Korea, Singapore, Malaysia and other countries in the region as well. In general we are likely to see a high correlation between what happens with the renminbi and what happens with these other currencies. I believe this is another important piece of the rebalancing puzzle as China moves to a floating rate and will amount to a significant, long-term structural change in the global economy.

In my view, we still have at least another 10 years of global rebalancing ahead of us. In terms of the U.S. consumer, the debt to disposable income ratio has fallen from 130% in Q3 2007 to 116% in Q4 2010.<sup>14</sup> However, that is still well above the historical average of just 75%. The savings rate has gone from 1% to close to 6%.<sup>15</sup> Even if 80% of that savings is allocated toward a repayment of debt, it will require at least the next decade to get consumer debt to 90% of disposable income, still high historically but at least more manageable. The same thing may happen in the U.K. and other countries where consumers have run up high levels of debt.

There is an even more difficult problem with public sector debt. In my view, governments have promised more than they can deliver in the long term. In the U.S., officials have not seriously begun addressing the out-year liabilities presented by programs like Medicare and Social Security. At the moment, I believe U.S. officials are tinkering at the margin in terms of discretionary spending, which has little to do with the long-term budget problems.

Global rebalancing will be a steady, multi-year process, but I think there are likely to be disruptions along the way. In my view, the U.S. Congress and the administration do not seem ready to address long-term entitlement reform until we have a crisis.<sup>16</sup> One catalyst might be if the supply of Treasury debt begins putting pressure on interest rates. For the moment, investors are willing to give the U.S. Treasury the benefit of the doubt that it will repay. But continued deficits of 10% of GDP and a debt to GDP ratio above 100% could wear their patience thin. I think the process could be more disruptive than what markets are currently anticipating.

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<sup>14</sup> U.S. Federal Reserve Flow of Funds reports.

<sup>15</sup> U.S. Bureau of Economic Analysis as of February 2011.

<sup>16</sup> On April 18, Standard & Poor's issued a warning that the credit agency might lower the U.S. credit rating if the government does not pare back its debt. U.S. government debt prices fell on the news but soon recovered, as did equity markets. The following day the Obama administration announced Vice President Joseph Biden would lead talks with Congress on reducing the deficit. See "Stocks Sink After S&P Warns on U.S. Debt," *Associated Press*, April 18, 2011, and "Biden Emerges to Lead Deficit Talks," *Bloomberg*, April 19, 2011.

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In my view, wherever leverage has expanded, foibles can be found, and I believe the history of financial market innovation is replete with episodes of financiers gone wild.

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Slower economic growth and higher unemployment in the U.S. are likely to persist for some time as a result of the ongoing deleveraging needed in the developed world. Nevertheless, I expect a gradual rise in U.S. interest rates as deflation fears fade. I believe investors should consider positioning their portfolios for higher rates at this stage. Some of the areas in fixed income we think are still attractive are the high yield markets in the U.S. and Europe and local currency emerging market debt. I believe opportunistic and go-anywhere types of strategies might give investors greater flexibility to hedge inflation risk and capture incremental increases in growth anywhere in the global economy.

I do think we are approaching the final stretch of the global credit cycle. The developed world had too much corporate debt in the late 1990s, which ultimately led to the 2001 tech bubble bursting. Then the consumer sector levered up with too much housing debt. Then that collapsed. Now the government side is leveraging up. While I hope we don't have a financial crisis as a result of this, if the developed world does not seriously address its long-term debt problems, we are likely to see interest rates in the developed world go much higher. In the end, that is what credit risk is. If you are not doing the right thing to restore fiscal balance, then the markets will likely punish you.

## Credit Cycles and the U.S. Experiment in Quantitative Easing

**David Cameron**  
**Chief Executive Officer**  
**The Boston Company Asset Management, LLC**

I believe that if investors want to assess asset pricing properly, particularly with regard to market bubbles, they need to study credit cycles. Bubbles tend to be credit-driven, and the debt that creates them generally expands over one of three time frames. Over the shortest time frame, which is the business cycle, credit expansion and contraction are somewhat predictable and only modestly disruptive. Much more impactful are two longer-term trends. The first is measured in centuries and tracks society's inexorable march toward greater financial innovation. Financial innovation results from the capitalist system's efforts to find new ways of financing increasingly complex real economies. Over the very long term, financial innovation expands the deployment of capital relative to the underlying stock of real economic resources. Capital efficiency might be the goal, but leverage is often a by-product. In my view, wherever leverage has expanded, foibles can be found, and I believe the history of financial market innovation is replete with episodes of financiers gone wild. During such episodes, creative bankers can potentially develop instruments that are complex, mispriced in terms of risk and overshoot their intended purpose. Asset-backed securities, CDOs and credit default swaps are notable examples from the most recent phase of financial engineering. While the process of financial innovation can be messy, I believe that over the long run, market intelligence eventually catches up and capital efficiency marches on.

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Leverage works as long as the underlying investment generates sufficient return to finance carrying costs. This becomes increasingly difficult to achieve at extreme levels of leverage.

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The other long-term influence on credit is the debt super cycle, which evolves over three to four generations. This super cycle waxes and wanes with investor attitudes toward debt, attitudes that correspond to risk appetites formed by each generation's life experiences. Because the generation of the 1930s experienced the effects of a massive credit contraction first hand, they perceived the risks of debt very differently compared with their children and their grandchildren. The 1930s generation spent the rest of their lives living frugally to avoid the risk of excessive leverage. As generations passed, fewer people had that direct experience with the Great Depression. By the 1990s, I believe the potential dangers of debt were nearly absent from the real-time psyche of the average market participant.

Seventy years ago, total debt in the U.S. (public and private) peaked at 3.5 times GDP.<sup>17</sup> The next 20 years was a period of deleveraging, and by the 1950s, total debt had declined to 1.5 times GDP.<sup>18</sup> That was the bottom of the super cycle. From there, each subsequent generation and business cycle witnessed an increasing appetite for debt financing. By the 2000s, most risk measures, in my view, revealed that any lingering concern about leverage had completely evaporated. Total debt in the U.S. had soared once again to 3.8 times GDP.<sup>19</sup> In my view, such debt loads are ripe for collapse, as super cycles in credit tend to buckle under their own weight. Leverage works as long as the underlying investment generates sufficient return to finance carrying costs. This becomes increasingly difficult to achieve at extreme levels of leverage. From the perspective of the total economy, the efficiency of debt can be measured by the amount of corresponding growth it generates. At the beginning of the current super cycle, each dollar of debt generated 70 cents of GDP; by the 2000s, the ratio had eroded to 14 cents.<sup>20</sup> The declining marginal utility of debt weakens the ability to finance carrying costs and erodes the sustainability of the credit expansion. As a result, credit bubbles burst and the assets inflated by bubbles deflate. The loss of wealth can be dramatic, affecting attitudes toward debt for a generation. In my view, this sets the stage for a process of deleveraging, and the cycle repeats.

In the U.S., private sector deleveraging is underway, but I believe with a significant difference this time around. Private sector deleveraging has been offset by a massive levering of the public balance sheet. In terms of public policy, I think this all adds up to a bold experiment. In my opinion, the policy is essentially Keynesianism on steroids, remarkable in that it is structurally supported by a hyper-accommodative Federal Reserve policy. In my view, the net result is dramatically low real interest rates and an irresistible temptation for investors to take on risk again.

Informed by the deflationary damage of the 1930s and other historic periods of deleveraging, U.S. Federal Reserve Chairman Ben Bernanke seems to have concluded that a protracted output gap is unacceptable in that it can lead to chronic unemployment. For Chairman Bernanke, employment risk seems to supersede the risk of rampant inflation, which critics claim his policy might unleash. At the core of Bernanke's view, I believe, is the effect chronic

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<sup>17</sup> U.S. Department of Commerce, U.S. Department of Labor, U.S. Federal Reserve Board and Ned Davis Research.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Ibid.*

<sup>20</sup> Ned Davis Research and The Boston Company proprietary estimates.

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For investors, slow deleveraging does not necessarily imply orderly markets. In my opinion, if current Fed policy persists, we will likely see years of spectacular cycles in asset pricing: bubbly markets followed by painful crashes, each contributing to dampened risk appetites over the long run.

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unemployment might have on a younger generation of workers deprived of the skills needed to run the future economy. For him, avoiding that outcome appears worth taking the risk that quantitative easing might fuel inflation. Bernanke appears to believe that risk is low and that when necessary, the Federal Reserve can simply withdraw liquidity from the economy to circumvent inflation. No one knows the final outcome of this experiment. But given the challenges of leads and lags when it comes to managing inflation, I believe the risk of policy error is high.

For me, the current episode in the debt super cycle is remarkable in how dramatically Fed policy has reignited risk appetites, pushing up investor demand for carry trades around the globe, in which investors borrow at low interest rates in one market and invest at higher rates in other markets. Critics of the Fed question the wisdom of using asset prices in this way as a mechanism to execute monetary policy and fear this approach could feed future bubbles. I believe the current state of affairs in which low interest rates in the U.S. are helping to finance booms in, for example, emerging markets, precious metals, and energy is reminiscent of what happened under former Fed Chairman Alan Greenspan. Greenspan kept interest rates low to offset the dot.com bust of the early 2000s, but those low rates helped feed the subsequent real estate boom.

On the fiscal side of public policy, debate about government spending and austerity is under way in the U.S., but I believe adjusting to lower levels of government services will be a slow process. In the long term, in my view, deleveraging is still the most likely outcome, but at a protracted pace and accompanied by a series of cycles that gradually grind debt down without ever tipping the real economy into a deflationary stall. I believe in 15 or 20 years, we may look back and see that this process accomplished exactly what occurred in the credit collapse of the 1930s, but over a longer period of time.

For investors, slow deleveraging does not necessarily imply orderly markets. In my opinion, if current Fed policy persists, we will likely see years of spectacular cycles in asset pricing: bubbly markets followed by painful crashes, each contributing to dampened risk appetites over the long run. While disruptive, I believe volatility will create opportunities for astute investors. If the Fed continues to keep monetary policy easy, the dollar will, in my view, likely remain weak and U.S. investors may steadily shift away from U.S. dollar-based portfolios. Given that U.S. investors are so heavily biased toward dollar-based assets, I believe the shift away from this bias may take years to unfold and potentially create opportunities for investors who can get in front of the trend. Moreover, I believe the inflating and bursting of periodic bubbles might create attractive valuation opportunities for the prepared investor. With the prospect of significant asset mispricings ahead, I believe it will be wise for investors to be cautious with inflating markets and ready with cash when crashes present buying opportunities at the security, sector or country level.

## Picking Your Spots in a Shifting Marketplace

**Alexander Huberts, CFA**  
**President, Investments & Finance**  
**Mellon Capital Management Corporation**

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If the risk is that the politicians do not get their fiscal houses in order and debt burdens continue to rise, at some point in that cycle there may be an opportunity to short certain sovereign bonds. But to express that view, you need to be flexible and have the operational capacity to establish short positions.

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Deleveraging is a complex process. I believe there is clearly a price to be paid because of the debt overhang, but let's not forget that the U.S. economy is growing again. Policy stimulus was an adrenaline shot that got us going again. While I did not strongly support QE2, I understood that the Fed was trying to let the private sector rebuild confidence after staring into the abyss of a complete collapse. I believe we are on the right track now and do not know if we could have achieved that without quantitative easing. Without economic growth, it is going to be very difficult for governments to delever. Getting us to the point where we have a chance to grow again was extremely important.

Generally, I believe the rebalancing process is proceeding well between emerging markets and developed markets. The biggest risk is that the rebalancing will stop and we will see lower GDP growth and possibly more protectionism in countries as a result. When growth stalls, countries tend to take action at the expense of their neighbors, whether it is on the currency front or elsewhere. The world has seen the trade imbalances of the last few decades create pockets of wealth in the form of sovereign wealth funds. Given the large size of these pools of capital, there could be trouble for the world economy if some of those actors begin to misbehave. But I believe the majority of those funds, like China's, have behaved very responsibly so far. They appear to be very cognizant of their responsibilities as global financial players and the interdependencies that result from that.

In my observations of the developed world, the corporate sector has derisked and delevered. The consumer has partially delevered and is beginning to increase savings. Of course, the public sector has massively relevered, seeking to ensure that economies did not descend into a full-blown depression. How political leaders manage that debt is the great unresolved question.

Corporate debt appears less risky than before, but the yields have already come down, so I believe most of that opportunity has probably run its course. Public debt may provide an investment opportunity from the short side. If the risk is that the politicians do not get their fiscal houses in order and debt burdens continue to rise, at some point in that cycle there may be an opportunity to short certain sovereign bonds. But to express that view, you need to be flexible and have the operational capacity to establish short positions.

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Nearly all asset classes are affected by the current conditions but not in a uniform way. We believe this creates great opportunities for global macro investors like us because we can move around the world and pick what we consider to be the best asset classes and the best regions at any particular time.

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The outlier on the public sector debt front is Japan, with its debt running at 200% of GDP, without even accounting for the repair costs following their triple disasters. They are now paying 10% of their budget on debt service. If global inflation rises and interest rates go up, that debt burden could escalate significantly, making the political situation far more dire. If the government spends 20% or more of its income on maintaining the debt, there will be less money for public service needs and social tensions are likely to build.

In my view, there is an outside risk that if this easy fiscal and monetary policy continues in the developed world for too long, confidence in even the highest-quality debt can suffer. And that process can be non-linear. With sovereign credit risk, there is no absolute number of moving from, for example, 30% to 60% of debt to GDP or 60% to 90% before the markets lose confidence. Rather it is a combination of factors such as whether a country is deemed able to grow out of its debt and what the interest rate trajectory looks like.

At Mellon Capital, we think this is the kind of macroeconomic environment where it is important to be judicious about your selection: whether it is region, asset class, or timing. Nearly all asset classes are affected by the current conditions but not in a uniform way. We believe this creates great opportunities for global macro investors like us because we can move around the world and pick what we consider to be the best asset classes and the best regions at any particular time. In our view, if you are faced with a dynamic macroeconomic environment, you need to pick your spots. You need to be global, flexible, and nimble.

As the macroeconomic landscape shifts, new information becomes available and new crises can arise. Those conditions might create new investment opportunities. Or they might create a situation where it is important to take risk off the table.

At Mellon Capital, we are tactical operators. We believe the three- to five-year outlook is probably reasonably positive. As we move through this period of heightened volatility, we believe our flexibility is the key to capturing the opportunities or de-risking where appropriate. That is a more conceptual approach than saying specifically that, for example, investors need to be in Asia. Our approach is to avoid locking ourselves up for very long in one area. We seek to invest in attractive opportunities whenever and wherever they arise.

# Shrinking Market Cycles

*Charles Dolan*

**Chief Strategist, Fixed Income, Cash and Currency Group  
BNY Mellon Asset Management**

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What strikes me about the current environment is the dramatic shortening of the market cycle. Now virtually everyone, even a mid-level analyst, can remember two major crises. This is unique in financial history.

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What strikes me about the current environment is the dramatic shortening of the market cycle. Now virtually everyone, even a mid-level analyst, can remember two major crises. This is unique in financial history. Many people who were around in 2001/2002, when the tech bubble burst, have now witnessed the housing and credit crash just a few years later. I have always been interested in trying to detect incipient bubbles. Most recently, for example, I have been asking our leveraged loan experts how the market is treating covenant-light loans versus standard term loans. Towards the end of last year, they said covenant-light loans were reappearing but at a 150-basis points premium. Then that premium fell to 100 basis points, and now they are being offered at the same rate. Furthermore, when you talk to credit experts in other areas, they say that not only are spreads getting tighter, but a few risky loans are surfacing that have underwriting standards reminiscent of the bubble days of 2005/2006. I find it remarkable that this is happening just a few years after the latest crash.

I believe this is because we are in an environment where the pools of capital have become much larger, and institutional investors are hungrier for returns. The reasons for return hunger run the gamut from pension shortfalls to sovereign wealth funds that want to keep up with their own nominal growth, which is what they need to do to establish rainy day funds. In my view, roving global capital is shortening the market cycle, which means we are probably going to have mini bubbles and mini crashes on a more frequent basis. What that means for investments is that people who allocate to a sector and stay long that sector might have problems; while investors who focus closely on security selection will likely benefit. I think overall there will be a tendency for security selectors and risk controllers to do better in this environment compared with investors trying to ride the market, which is much more difficult to do in stormy waters.

I think this environment is good for active managers who don't get too exposed to market or sector betas. By that I mean managers who outperform through small active timing decisions and security selectors who control their concentration exposure quite carefully. For investors who are not in the market on the daily basis, credit is looking like the best thing in the world at the moment. One of our hardest challenges is to persuade investors to avoid the hunt for yield. Other investors will keep getting longer on credit, and that will likely create the next bubble. We will likely have another dislocation, even though it probably won't be as severe as the last one.

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I believe the investors likely to prosper in an age of global rebalancing will need to monitor all the risks: secular and cyclical, political and fundamental. Opportunities will arise, but in my view they will not last even an entire market cycle.

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In my opinion, because we are likely to have lower growth, I expect we'll have less of a persistent term premium. Overall returns in all asset classes will be lower, and people will need to save for longer to meet their goals. Over the cycle, investors will get some return for their cash and from government bonds, but I believe much of the return will be for investors who take equity-type risk. Some of that will be default risk in credit, but it will be risk that is linked to growth.

I also think there will be fewer convergence plays. Some the largest active returns since the late 1970s have been due to a convergence in market prices as investors recognized changes in the world. For example, investors recognized changes in Europe whereby higher-risk countries were converging with lower-risk ones, compared with how investors regarded those countries in the 1970s. The re-rating of the risk translated into capital gains for investors who were long those markets.

Emerging markets are another example of convergence. The interplay between growth prospects, debt dynamics and currency risk has turned some emerging markets into safer and lower yielding investments than previously "safe" developed markets. To gain the maximum benefit from emerging markets, fixed income investors will need to be in other sectors when these markets are very expensive.

I believe the investors likely to prosper in an age of global rebalancing will need to monitor all the risks: secular and cyclical, political and fundamental. Opportunities will arise, but in my view they will not last even an entire market cycle. The necessary rebalancing will likely take multiple market cycles, and I believe flexible investors with long time horizons will be able to reap the potential benefits.

## Back to the Future: Equities Regaining Favor

*Phillip Maisano*

**Chief Investment Strategist, BNY Mellon Asset Management**

**Vice Chairman and Chief Investment Officer, The Dreyfus Corporation**

The process of rebalancing is at different stages in different areas in the world. In the U.S. there is a massive deleveraging of the consumer under way. Consumer balance sheets are improving; credit card use has declined dramatically. There is far less home equity value to borrow against, so those debt levels will eventually equalize. Housing values will eventually equalize as well, either through paying down the debt or some price appreciation, but I believe we will never again see the kind of lending we experienced during the housing boom and home prices will stay low for a prolonged period. The deleveraging of the corporate community has been going on for years, so their balance sheets are in better shape than they have been in 20 years. Even the banking system has recovered very quickly because of the government subsidies.

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Unlike the “new normal” heralded by many, I believe we are simply experiencing a stabilization of interest rates to the point where they should be relative to reduced borrowing demands. This, I believe, will have implications for the relative attractiveness of bonds versus equities for investors.

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I believe the result of this is that there will be less borrowing overall and at lower costs, with lower bond issuance. There is likely to be more opportunistic borrowing now where investors think they can earn more than the cost of borrowing. Rather than credit growth, I believe we will see a very stable credit situation going forward. Corporations do not need to borrow, and individuals who need to borrow might not be able to because of stricter lending standards. Only the U.S. government will continue to borrow on a significant level, though there are strong deleveraging pressures.

I think the securitized market will continue to operate but in a very different form and magnitude. Securitizations will be simpler, without the complicated slicing and dicing of credit risk we saw previously. Derivative instruments are likely to be more straightforward. The days of CDO squared and CDO cubed are over, because the crisis made it very clear that no one knew how to accurately price those instruments. I think the lessons of agency risk and disintermediation in the securitized markets mean that credit is going to be more expensive and harder to get. If banks know they can sell forward every loan they make, they are likely to be less stringent about origination, as we saw during the housing boom.

In my view, the decline in demand to borrow will help keep interest rates low. Unlike the “new normal” heralded by many, I believe we are simply experiencing a stabilization of interest rates to the point where they should be relative to reduced borrowing demands. This, I believe, will have implications for the relative attractiveness of bonds versus equities for investors. In 2009 we saw a massive reallocation away from stocks toward bonds as investors reacted to the steep declines in equity values during the global financial crisis. While many observers expect a shift into fixed income as baby boomers approach retirement, I think the risk is that move might result in declining purchasing power, especially if we are looking at a 20- or 30-year retirement period. Bonds have their use, but if interest rates stay relatively low, their utility as a source of income is likely to be very limited, especially considering they offer no protection against inflation.

Instead, I believe we will see a “back to the future” reappraisal of equities as an important source of income and inflation protection. We are already seeing equity instruments becoming more yield-oriented. Companies are already talking about dividend increases and buybacks, as a way to return cash to investors while holding a cushion on their balance sheets. I believe equities will draw more capital because, in addition to enhanced yield potential, they provide inherent inflation protection. This is how investors regarded equities 40 years ago: a source of inflation protection, and two-thirds of the return was yield. The stagflation of the 1970s amended that calculation, but I believe that if inflation stays within the historical norm, equities will become competitive relative to bonds.

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I believe we will see a “back to future” reappraisal of equities as an important source of income and inflation protection.

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While U.S. equities have fallen out of favor over the last few years, I believe U.S. companies, especially those with large international exposures, are poised to perform well. Of the major industrialized economies, I believe the U.S. has a significant structural advantage over Europe and Japan in the form of the boost immigration provides to our demographics and, by extension, to growth. For me, this means equities can perform well in a setting where both interest rates and inflation rates are relatively low.

I am far more pessimistic about the Eurozone area because of their difficult demographics and the structural issues that make a single European monetary policy inappropriate for countries with such divergent fiscal situations. Their populations are declining and they face massive difficulties integrating weaker economies. Having said that, I do believe the Eurozone will remain intact, mainly because I believe German officials will ensure it does so. Apart from popular discontent in Germany about subsidizing weaker members of the Eurozone, German businesses recognize that the Eurozone has been a boon for them. A return to the deutsche mark would make Germany highly uncompetitive in the global economy. Nonetheless, the currency union faces an uphill battle in dealing with its highly indebted members and resolving the contradictions of a single monetary policy for countries that present highly divergent growth conditions.

In my view, Japan will certainly be weakened by its latest disasters and its own demographic challenges, but it still has a healthy export business to emerging Asia. It also continues to support a strong technology base, which emerging Asia requires. I believe investors must be very selective in investing in Japan, but there are still strong Japanese companies with healthy fundamentals and booming export businesses that are increasingly based in emerging Asia. Like Australia, their sheer geographical proximity to the fastest growing markets in the world is a huge competitive advantage. To that extent, I have more confidence in Japan than in Europe.

The unanswered question for Japan is how long they can continue to finance their huge levels of debt domestically. For as long as Japanese savers are content to buy government bonds, the government will be able to self-finance its debt. But as the population ages and moves from the accumulation to decumulation phase, it is not obvious to me that the government can continue to rely on domestic buyers of its debt. While repairing the damage after the earthquake and tsunami is likely to have a stimulative effect on the economy, it will also add to the country's debt burden. It is difficult to predict exactly when Japan will reach the limit of self-financing its debt, but it is clear that at some point the interest rate on their debt will rise because the government will have to draw capital funds from somewhere else.

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The process of global rebalancing is likely to have broad and protracted effects on growth rates, interest rates and inflation rates. These, in turn, will affect capital markets throughout the world in dynamic and unpredictable ways.

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Beyond the developed world, consumer spending is already shifting to the developing world as consumers there see their wages rise. For me, the implication of higher growth in the emerging world for capital markets is clear: capital is going to become more expensive globally. Again, I believe that should make equities preferable to debt.

I also believe that we will see higher levels of volatility in the markets. While I believe that kind of environment might give hyper-active managers an opportunity, I see it as a potential enemy of pure active managers. In my view, normal volatility can be good for active managers, but abnormal levels can lead to distortions in the market. My concern is that investors tend to trade ETF baskets or indexes when there is volatility of the kind we are currently seeing. In other words, they are trading the market, not selectively trading stocks.

I believe you can argue that the proliferation of ETFs has distorted markets. In my view, ETFs drive capital flows to companies that do not necessarily deserve them. Instead, they receive capital simply because they are part of a narrowly defined ETF box. So my concern is that the growing popularity of ETFs could potentially undermine the market's role as an efficient allocator of capital.

## Conclusion

The global economy is facing unprecedented challenges, as the developed world seeks to unwind its high levels of debt and the emerging world seeks to move toward a more domestic-consumption-oriented growth model. As our investment experts have indicated, the process of global rebalancing is likely to have broad and protracted effects on growth rates, interest rates and inflation rates. These, in turn, will affect capital markets throughout the world in dynamic and unpredictable ways. We encourage debate on these issues in order to showcase the complexities global investors will likely face in an increasingly interdependent financial system. As many of our experts have commented, investors need to be mindful of the risks these uncharted waters present at the same time they are alert to the potential return opportunities skillful investing might offer.

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