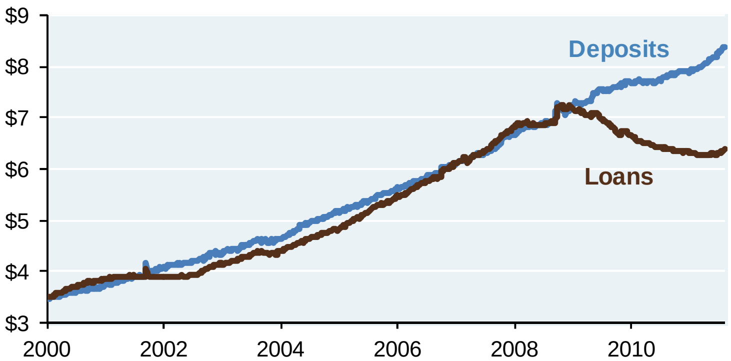
Topics: A short note on G3 monetary policy and your family spending

Market Update: another Jackson Hole economic policy symposium approaches this Friday, just as the equity market bounce from the last one has almost disappeared. Markets are hoping for the Fed to:

- make long-term interest rates lower even though they're already low (2.2% on 10 year Treasuries), perhaps through some kind of "Twist" operation that also removes shorter-term liquidity
- add liquidity through asset purchases even though there's plenty of it in the system
- "encourage" banks to lend more money by eliminating interest on excess reserves held at the Fed, even though banks are struggling with insufficient loan demand [first chart], and surveys show a substantial relaxation of lending standards
- buy corporate bonds, even though investment grade spreads are 85% of their way back to 2007 levels

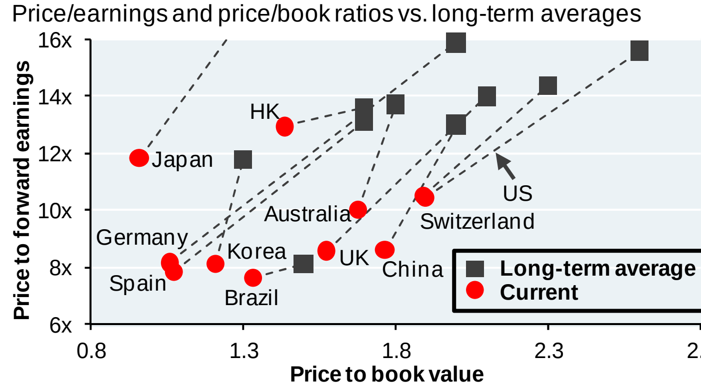
Hope springs eternal. Meanwhile, after the summer decline, global equity markets are priced at 8-12x forward earnings and 1.0 – 1.5 times book value [second chart]. In the US, we expect 1% growth instead of a recession; if we're right, it's mostly in the price. In Europe, there is almost a total eclipse of economic and corporate profit issues by policy decisions. I read commentary recently suggesting that while German politicians in the governing CDU[1] say they are *not* in favor of Eurobonds, they actually *are* willing to support them, but are waiting for adverse market pressure before proceeding. This kind of political kabuki is not new[2], but can have unexpected consequences. Bottom line: this is not investor-friendly territory; more on all of this after Labor Day. This week, **a look at G3 monetary policy intentions (low rates for a long, long time) and your family spending.**

US banking system: too many depositors, not enough borrowers, Trillions, USD



Source: Federal Reserve Board weekly H.8 report.
Loans exclude assets reclassified under FASB Statement 166.

The men who fell to earth
Price/earnings and price/book ratios vs. long-term averages



Source: J.P. Morgan Securities LLC. P/B long-term avgs since 1980 except for Korea, China, Brazil (1995). Fwd P/E long-term avgs since 1987 except for Brazil, China (1995).

Zerophilia and your family spending

The term zerophilia is how we describe the inclination by Central Banks to rely on quasi-zero interest rates as a means of reinvigorating both financial markets and private sector demand. Fed logic: impairing the real value of cash and bonds leads inexorably to higher risk appetite and higher returns on riskier financial assets (the Portfolio Rebalancing Channel[3]). However, this logic has a decidedly mixed track record, and is unreliable as an investment strategy to offset the impact of zero interest rates. As a result, our focus on generational wealth leads us to pay attention to spending patterns as well as investments.

One consequence of zero interest rates is the increasing likelihood of negative real returns on cash and bonds, which for many families, comprise a large part of their investment portfolio. This seems fairly intuitive, but let's put some numbers on it. The inclination by families to rely on cash and bonds for positive real returns is based on history. Using Robert Shiller's data, we looked at the realized real returns on long-term bonds since 1871 [see chart on following page]. With the exception of bonds purchased right before world wars and in the early 1970's, long term bonds generally delivered positive real returns, sometimes quite substantial. The real returns on cash are of course lower, but the contours are the same: positive except for wartime, and the 1970's. Zerophilia and the Great Recession have now created another vortex of evaporating real returns on cash and bonds, with implications for family spending.

[1] In Germany, the governing CDU is reportedly against Eurobonds right now. If the next election were held today, current polling shows that the Greens and the SPD would control the Bundestag; both parties are in favor of Eurobonds, as are the minority Linkspartei [Left Party].

[2] According to sources like WWII Rear Admiral Robert Theobald, FDR wanted to enter the war in Europe, but due to isolationist sentiment in the US, issued a proclamation of neutrality in 1939, and promised the country as late as 1940 that the US would stay out of it. FDR then tightened the noose on Japan (including an oil embargo), waited for an attack, and entered the war with much greater support.

[3] See speech by Janet Yellen, Vice Chair of the Board of Governors of the Federal Reserve System, at the Brimmer Policy Forum, Allied Social Science Associations Annual Meeting, Denver, Colorado, 8 January 2011.

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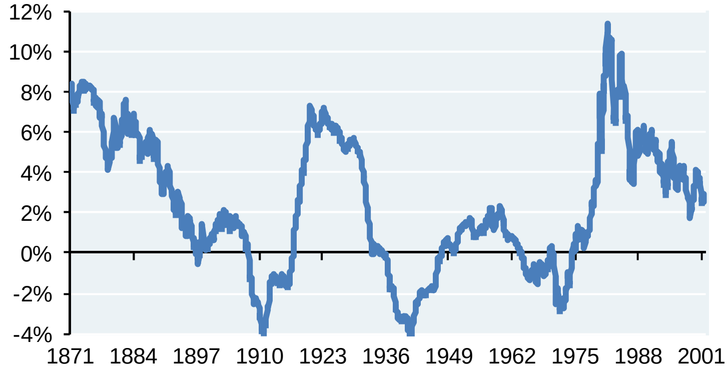
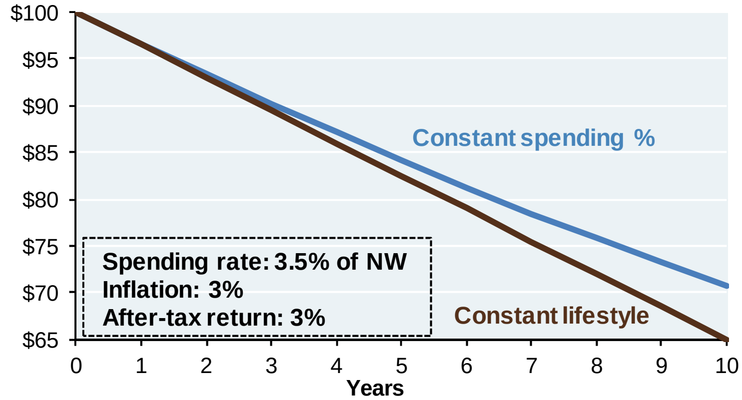
Consider the following: a 3% after-tax portfolio return, an annual family spending rate equal to 3.5% of liquid net worth (something we witness frequently), and inflation of 3%. After a few years, the portfolio will have been drained of a quarter of its real value. If we assume a constant lifestyle instead (fixed real dollars rather than a percent of net worth), the portfolio decline is even faster. We do not assume earned income, since *any* amount of spending can be supported if earned income is high enough. The focus is on portfolios supporting their beneficiaries (retired, or no longer in peak earned income years).

The real returns from investing in long-term bonds
Shiller long-term interest rate minus forward 10-year realized CPI



Source: Robert J. Shiller.

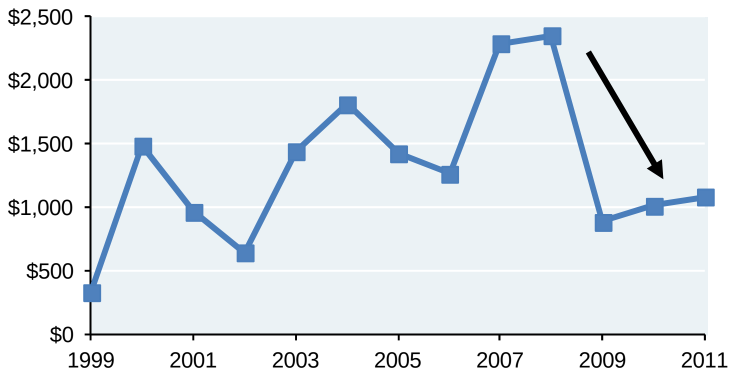
The paradox of spendthrifts
Dollars, in real terms



Source: J.P. Morgan Private Bank.

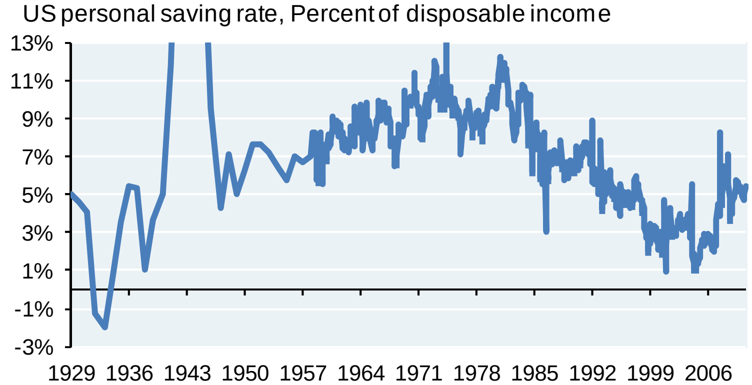
Two obvious conclusions: for many families, spending plays a large role in the ultimate accumulation of wealth; and since monetary policy is now specifically designed to **impair** the value of accumulated savings, spending habits may need to be re-calibrated. To personalize this discussion, I downloaded my spending on Amazon.com over the last decade. While this is not a perfect proxy for my family spending, it does capture my greater inclination towards thrift with the onset of Zerophilia and negative real returns on cash and government securities**.** At a national level, saving rates have risen modestly. Many economists do not believe they will rise further than 5%, and believe that the credit bust is "over", given the large decline in household debt service relative to disposable income. But this latter development is more a reflection of zero interest rates than actual paydown or dismissal of debt balances, which means that a lot of zombie balance sheets are still lurking.

My personal expenditures on Amazon.com: adjusting to Zerophilia



Source: Amazon.com, Michael Cembalest.

A return of household thrift at the national level
US personal saving rate, Percent of disposable income



Source: "Department of Commerce Historical Statistics, Colonial Times to 1970", Bureau of Economic Analysis since 1959.

For our clients, I can imagine no task more daunting than conveying the need for thrift to family members. It has been a long time since thrift was considered a national virtue by economists and journalists. Paul Samuelson's first *Economics* textbook in 1948 argued that high consumption brought health to a nation, while thrift could be a social vice. As far back as the 1930's, H.L. Mencken in *American Mercury* magazine expressed contempt for the "curse of thrift". Charles Angoff's *Literary History of the American People* (1931) described Franklin's *Poor Richard's Almanac* as "a colossal misfortune in the United States… Franklin represented the least praiseworthy qualities of the inhabitants of the New World: miserliness and fanatical practicality"[4]. And of course, there was Keynes warning of the paradox of thrift in his *General Theory* (1936). Eisenhower, aware of being seen as an "unsympathetic, reactionary fossil", was a post-war exception.

[4] "*The Decline of Thrift in America: Our Cultural Shift from Saving to Spending*", David Tucker, 1991.

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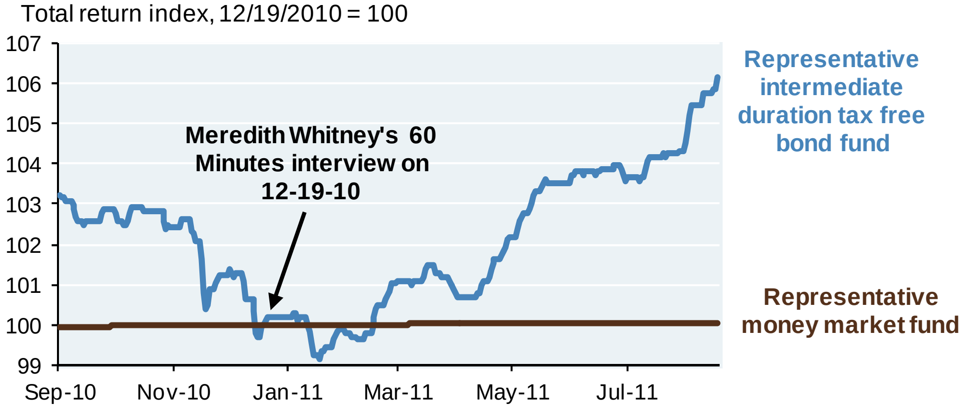
However, a lot has changed since the United States was threatened with dangerous and excessive household thrift. Luxury goods sales by LVMH, Tiffany's, PPR (Gucci, Yves St. Laurent), BMW, Porsche and Mercedes are rising at a rapid double-digit pace. According to the New York Times[5], Nordstrom has a waiting list for a Chanel sequined coat that costs $9,010, and Neiman Marcus has sold out in almost every size of $775 Christian Louboutin "Bianca" platform shoes. On the **absurdity of this latter point**, researchers at Northumbria University (UK) have found that men generally don't notice the difference between high heels and regular shoes anyway.

Perhaps the best thing to do is show family members, beneficiaries and other constituents our "Capitol Grill" menu from the July 29th EoTM: a lot of options on the revenue front focus squarely on high net worth families. The latest idea, from the Brookings Institution's Tax Policy Center: **creation of a new 50% marginal tax rate on ordinary income over $1 million**. According to the TPC, revenue raised over 10 years: $472 billion, assuming the rest of the Bush tax cuts do not sunset. As a result, it's not just monetary policy that squeezes family income, but possibly tax policy as well.

There are investment opportunities to increase portfolio income, such as the increase in leveraged loan spreads and bank preferred stock yields in the last few weeks, as well as select multinational US and European stocks with 3%-4% dividends. We also advised US clients not to part with long-duration municipal bonds last winter when the municipal default craze gripped the market (as shown below, the municipal exodus prompted in part by Meredith Whitney's *60 Minutes* interview has turned out so far to be spectacularly bad timing). Investment opportunities aside, a collapse in G3 yield curves presents a challenge to many families who have not reset their spending patterns to adjust to this new reality. To be clear, zero policy rates forever is not our base case, but increasingly, reality is not looking like anyone's prior vision of the future.

Michael Cembalest
Chief Investment Officer

Municipal bonds, cash and 60 Minutes
Total return index, 12/19/2010 = 100



Source: J.P. Morgan Asset Management.

[5] "*Even Marked Up, Luxury Goods Fly Off Shelves*", New York Times, August 3, 2011.